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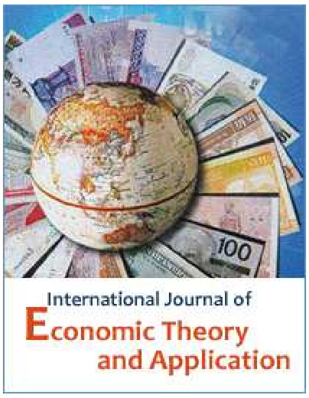

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The European Monetary Union: Creation, advantages, today's problems

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Abstract
The paper presents of the European Monetary Union as a result of process of the European integration. The main historical aspects the European integration are discussed in the article. The international role of European Monetary Union‘s common currency – Euro, its strenghtening in the pre-crisis period, its impact on the countries economy is analyzed. The present situation in the Euro zone , especially the problem of state dept and the measures taken by the institutions of European Monetary Union to solve this problem are discussed. Ihe analysis shows that the European Monetary Union will have long-term perspectives only if radical measures in the economic policy are taken.

1. Introduction

The integration process of Europe, the result of which is foundation of European Union, is one of the most significant processes, in the political and economic sense, during the whole history of Europe. After foundation of the European Union the establishment of the European Monetary Union (EMU) becomes the most important task. Formally EMU exist since January 1, 1999, and Euro as cash started functioning in twelve states of EU since January 1, 2002. Adoption of Euro ended the 50 year lasting money integration process. In the contest of the international monetary system, formation of European Monetary Union is perhaps the most important event since the failure of the world monetary system that functioned on the basis of the Bretton Woods treaty. When evaluating in the context of other monetary unions, the Euro project is a particular event in monetary history. Never before did it happen that a group of independent states would refuse their national money of their own will and would concurrently retain political independence. Euro introduction is of significance not only in economic, political, but also psychological terms. National money is an important symbol of national sovereignty. A voluntary change of national currency into Euro indicates that the general European identity is strengthening. Today the European Monetary Union has 18 European Union countries however its development process is not complete yet.

Issues of Euro integration in Lithuania are analyzed by Davulis (2009). The various aspects of Euro integration were analyzed by Benjamin (2007), Duisenberg (2002), Galati, Tsatsaronis (2003), Gaspar (2004), Greenspan (2001), Frankel, Rose (2002), Shalder (2005) and others.

The purpose of the article is to discuss the way of creation of the European Monetary Union, adoption of the Euro, its advantages and disadvantages, the present problems of the European Monetary Union and its perspectives. The methods used in the article are systematic analysis and generalization of scientific literature and statistical data. The resultat of research – it is found out that that the European Monetary Union will have long-term perspectives only if radical measures in the economic policy are taken.

2. An Historical Background for Founding the European Union

The European Union is, in a sense, quite a unique construct of countries having no analogues so far. A group of independent countries of Europe, which created a common internal market with a single currency, managed to preserve the political independence thereby. The creation of the common internal market of the European Union, which has its prehistory, is a part of further integration of the European countries. Such a creation of European Union was stimulatedboth by political and economic reasons. Even at the beginning of economic integration it has been realized that the European economic integration will not be sufficiently effective if the monetary sistem of these countries is not united and there will be no common currency. The idea of European Monetary Union was discussed as far back as in 1956 during negotiations of the Rome Treaty. As the key moments in the development of the European Monetary Union a few reports should be mentioned. Werner Report (1970), in which he was proposed to create the European Monetary System, consisting of a basket of currencies called an ECU and the Exchange rate mechanism, the Delor‘s Report (1989), which became the basis for the European Monetary Union plan established by the Maastricht Treaty.

In 1970 Luxembourg Prime Minister Pierre Werner presented in his report a plan to establish the European Monetary System by 1980. The main idea of this plan which the European Community members attempted to implement was to limit fluctuations of exchange rates. The maximum permissible fluctuation rate was determined – 2.25 percent as compared to the U.S.A dollar. Implementing the plan, the European Monetary Cooperation Fund was established in 1973 which provided loans to central banks of member countries, that were necessary in order to implement the exchange rate stabilization policy. But the situation in that period led this part of Werner‘s Plan to failure. Despite the failure of Werner‘s Plan, in 1978 the European Council approved the plan to create the European Monetary System which has been operational since 1979. The main points of this system were: the exchange rate mechanism, European Monetary Cooperation Fund and the European currency unit – ECU. ECU is a basket of currencies made up of each country‘s currency and included in this basket with a fixed weight. The exchange rate mechanism was the foundation of the European Monetary System. The countries – members of the European Monetary System had to determine and maintain their exchange rate in respect of other currencies within the limits.

The European Monetary System was not a monetary union in the real sense of the word yet and ECU was not the common currency of the European Community. In 1989, President of European Commission Jacques Delors proposed a plan to implement the economic and monetary union with a single currency – Euro. The Plan of Delors was particularized in the Treaty of the European Union. The criteria of convergence have been determined in the Treaty of the European Union and Member States of the Economic Monetary Union had to carry them out. In 1994 the European Monetary Institute was established under the Plan of Delors which replaced the European Monetary Cooperation Fund. The Institute took over and expanded the functions of the Fund.

The European Central Bank was established in 1998 as the core of the Eurosystem and the European System of Central Banks. It comprises the European Central Bank and the national central banks of all the European Union Member States, whether or no they have adopted Euro. The European Monetary Union has existed since 1 January 1999. Since 1 January 2002, Euro in cash – Euro coins and banknotes – hae been put into circulation in 12 Member States of the European Union. The Euro became the main axis of European integration. The euro project was a particular event in the history of money. It was unprecedented that a group of independent states would voluntarily give up their national currency and at the same time sustain their political independence. This act leads to a completely new combination of the macroeconomic policy which is based on common values.

3. Strengthening of the International Role of Euro in the Pre-Crisis Period and Its Impact on the Country's Economy

The adoption of Euro had a significant impact not only on European Union countries, but also on another states of the world. Euro replaced the majority of European Union countries‘ national money and has become one of the most important international currencies in the world. As a matter of fact, it has become the second major international currency after the U.S. dollar. Pisani-Ferry et. al. (2008) and Angeloni (2011) analyze the changes in the role of euro and the U.S. dollar in the world and the trends of the ratio of these in exchange rate. Statistical data in the U.S. dollar and Euro exchange rate show that the value of Euro to dollar was not steady. In 2004-2007 the value of Euro to the U.S. dollar was steadily increasing due to a sharply rising U.S. budget debt, however in 2007 the situation changed – the U.S. dollar strengthened versus Euro much as 22 percent. In 2009, due to the rising debt and uncertain financial positions the ratio between the U.S. dollar and Euro fell sharply again by 20 percent. In recent years, the euro exchange rate fell due to the Greek debt crisis and the poor financial situation of the southern European Union countries. At the beginning of 2011 the euro exchange rate to the U.S. dollar slightly increased and then remained stable (Amadeo, 2012).

According to Angeloni (2011), the possibility that Euro will be a strong and stable international currency once again and the European Monetary Union will cope with the challenges it faces in the financial sphere depends on the fact whether the European Union will take sufficiently hight fiscal and monetary control measures and carry out the necessary structural reforms.

The adoption of Euro has been a powerful stimulus for the development of financial markets. During the first three years since the introduction of Euro, financial turnover in the euro zone countries more than doubled as compared to the turnover of the national currencies. The Monetary Union and Euro have created preconditions for strengthening the position of the European Union as an international financial center for it to compete with the U.S.A, Japan and other countries. The euro adoption had an impact on the domestic financial markets of the monetary union as well (Galati, 2003). After the common currency has been introduced, transactions in national currencies have disappeared, at the same time the need to hedge against the exchange rate risk vanished. So the euro has consolidated and integrated financial markets of Member States of the European Monetary Union broadening thereby the diversity of financial measures (Samuels, Ramlogan, 2007). As noted by Gaspar (2004, 2003), the effect of Euro adoption on financial markets is much more stronger and displayed itself faster than on other economic sectors.

By eliminating the exchange rate uncertainty the common currency reduces risk and at the same time leads to a lower real interest rate. Falling interest rates encourage in turn the economic growth. The adoption of the euro eliminates the euro and the national currency exchange costs. This factor also has a positive influence on the volume of the national product. On the other hand the common currency had an impact on the growth of price transparency, increased the competition among producers in the euro zone and led to the possibility of more efficient allocation and use of resources in the euro zone.

One of the main advantages of joining the European Monetary Union is a positive impact on trade development in accession countries, i.e. the so-called Rose effect (Rose Engel, 2001). Rose has found that trade flows among the countries belonging to a monetary union are in average 100 percent higher than among the European Union countries outside the monetary union. It is important that this increase in trade does not occur at the expense of other countries, it does not reduce the volume of trade with them. The expanding trade in turn stimulates the economic growth. Frankel, Rose (2002) has defined that if the country's trade increases by 1 percent, the gross domestic product increases by about 0.33 per cent. A positive impact of the common currency on the trade among the countries of the European Monetary Union has been also noted by other authors. Micco et al (2003) have found that trade between the Member Countries of European Monetary Union increased by 15 percent during the period 1999-2002 and during the period 2002-2005 trading volumes again increased by 26 percent. According to Chintrakarn (2008), in the first year the trade volume increases generally up to 9-14 per cent between the two countries that have joined the euro zone.

The benefit of accession to the euro zone is not one-sided. The benefit can be seen not only in the new European Union countries which have acceded to the Monetary union but also in the whole euro zone. However, in the new countries of the euro zone the effect will be more signicant. The benefit of integration in the euro zone will reveal itself through the expansion of trade, integration of the financial sector, and via the euro international role. Joining the euro zone will allow for acceding country to actively represent the economic interests of the country and to participate in making economic decisions that effect the entire European Union. The most important economic decisions are determined by the countries belonging to the euro zone. The rest of the European Union countries have but little opportunity to influence those decisions.

One of the arguments against the adoption of the euro is based on the Balassa – Samuelson effect – the growth of productivity in the open sector is faster than in closed sectors because the first ones attract more technology-receptive foreign investment. Increasing productivity increases wages in open economic sectors which causes a need to raise wages also in closed sectors. In order to maintain the obtained profits, the prices have to keep increasing in closed sectors. So the Balassa - Samuelson effect means inflation growth within the country. According to the International Monetary Fund, the Balassa - Samuelson effect may increase inflation by 1-2 percent in the new European Union Member countries, if they are involved in the 2nd Exchange-rate mechanism (Schalder et al (2005).

The countries with the classical of monetary policy that joined the European Monetary Union will lose the independent economic policy instrument, and the European Central Bank will play the leading role there. Meanwhile, the European Central Bank implements the monetary policy with regard to the whole euro zone situation without stressing individual country‘s peculiarities. Therefore a common monetary policy may not be optimal for individual countries. However, the countries that have a model of the currency board or whose currencies are directly pegged to the euro do not lose anything because they do not have independent, real levers of monetary policy. On the other hand, the countries that have functional models of the currency board, acquire a certain similarity during the convergence process. This is because the exchange rate stability requirement is executed automatically.

If the majority of Eastern European countries join the monetary union today they would not avoid the price "shock", i.e. a significant increase of prices. Even in the most developed countries of Western Europe, for example Germany did not avoid a certain price increase even though it was not large. The lower the country's economic indicators than the average indicators in the most developed countries, the higher the price increase in those countries will be. Therefore it makes sense to join the 2nd Exchange-rate mechanism. That is necessary following the requirements of the Maastricht Treaty when a high degree of convergence is achieved, i.e., the country's economic indicators reached or are very close to the European Union average.

The psychological factors are also very important for Euro adoption. Just like the country's anthem, or the flag, the national money is perhaps the most notable feature of the country's sovereignty. To a certain extent the loss of national money can form a negative view of the country's population towards the euro.

Despite the advantages of the European Monetary Union provided for its members, according to some authors (Feldstein, 2011), the creation of the Monetary union was more benificial to stronger economies and in particular to Germany. Starting from 1999, i.e., from the adoption of Euro, Germany has accelerated the development of various economic sectors, significantly improved its balance of payments and has become the most competitive country in the European Union (Norris, 2011).

4. The Euro Zone Debt Crisis and Measures to Overcome It

The benefits and advantages provided by the common currency for the European Monetary Union Member – States have been explained above. In fact, the international significance of the euro has been steadily increasing, as well as the Monetary Union's economic power until the global crisis. The changed situation in the euro zone and weakening of the euro due to the global crisis caused doubts the benefits of the single currency. The single currency makes it impossible to take advantage of currency devaluation during the economic downturn in order to maintain the country's competitiveness in the international market Poland has made use of that, and managed to keep the country's GDP growth even in the full swing of the crisis. The stringent requirements of the Maastricht criteria to euro zone countries have limited the capability to carry out an independent fiscal policyfollowing the requirement to maintain the financial situation stability (Samuels, Ramlogan, 2007).

Some authors have questioned the benefits of the euro and the stability of the euro zone even at the beginning of the global crisis. Munch (2008) argued that this crisis could cause not only a crisis of monetary policy, but also a serious problem for the European Monetary union itself. Therefore it is necessary to establish an institution that would be responsible for dealing with the crisis. A similar standpoint was expressed by Evans-Pritchard (2008) who questioned the effectiveness of the euro zone and stressed the need for an institution that could ensure the stability of the common currency. Some authors like Jones (2009), Ioannou, Stracca (2011) argue that one of the main weaknesses of the euro zone is inefficient fiscal control. Even more rigorous approach to the single currency was expressed by Feldstein (2011), who called the euro a failed experiment which led to the current debt crisis in some euro zone countries to instability of many European banks, high unemployment and large negative trade balances. Meanwhile other countries have managed to control inflation for a decade without joining the euro zone, though the low level of prices is regarded namely as an advantage of the single currency. According to the author all these problems were inevitable since the single currency was introduced in very different countries not only in economic, but also political and traditional attitudes. To his mind creation of the Euro system was based not so much on economic than on political purposes. According to the author, most countries of the euro system would have avoided big debts and other economic problems if they have had the national currency.

The Euro crisis has soon erupted into_the euro zone debt crisis. Although one cannot say that the debt crisis of the euro zone is a direct consequence of the global crisis, but undoubtedly the latter, which highlighted the structural problems in the euro zone, influenced the euro zone debt crisis to a certain extent. Falling demand has forced the European Central Bank to reduce the basic interest rate while governments had to increase expenditure as well as budget deficits thereby in oder to promote aggregate demand and thus prevent the collapse of economy. With a low interest rate, there is no no major problem to borrow in the international market in oder to cover the budget deficit, so the problematic countries in the euro zone made use of that. However, when they have lost the trust of investors and the cost of borrowing increased, these countries were faced with the burden of debt and the bank liquidity problem. The countries of the Euro zone that refused their national currencies have lost the ability to print money and, by means of inflation, to reduce the real debt burden of the country.

The Southern European countries - Greece, Spain, Portugal, Italy, Cyprus and Ireland were becoming problematic countries of the euro zone debt crisis, the crisis has affected them most, but the reasons for them to become problematic are different. The base of Greece economics - tourism and shipping sectors - is highly dependent on external factors and therefore the global crisis has affected the Greek economy dramatically. Declining budget inflows, the government's inability to reduce the budget deficit and implement the necessary reforms posed a real threat that the national debt will become out of control. Greece was the first country in the euro zone that has lost the market trust.

Portugal has always been attributed to the economically weaker group of the euro zone countries - over the past decade, there has been almost no change in GDP per capita. The country's saving has been low even in economic upturn times, the country has been forced to keep borrowing. When investors lost trust in Portugal, the interest rates were increased ti it, which pushed the country into a debt crisis. The responsibility for the crisis in Spain should fall not on the public but private sector. After bursting of the real estate bubble, the country's construction sector had experienced a huge decline and increased unemployment. Due to a large part of debtors' inability to repay debts, banks increased deferments of bad loans which caused banks' liquidity problems. The reduction in consumption and income to the state budget forced the state to borrow from international markets. The main reason for lack of trust in Italy is a small country's competitiveness, too slow economic growth and government sluggishness in solving the country's financial problems.

Although Ireland is in the top ten countries in the world by the competitiveness indicator, its living standard is among the highest in the world, but its problems were caused by the government's decision to guarantee the liabilities of six Irish banks which financed the real estate bubble. Thus, in order to avoid a banking crisis, the Irish government transferred a part of the debt of the private sector to the public sector after the real estate bubble burst, in this way putting on its burden of the debt. Basically, Ireland, Spain and Cyprus faced not so much the public debt as the banks' liquidity problem. Hence the euro zone debt crisis is also a crisis of banks for another reason, namely the banks have acquired the largest part of the government securities of the crisis countries.

European Union institutions reacted to the situation in the euro zone and in the whole European Union. It should be noted that much earlier, even before signing the Maastricht Treaty, measures were provided that could ensure a sustainable economic growth of the euro zone members'. In June 1997, the European Council has signed the Stability and Growth Pact, which was designed to ensure the budgetary discipline in the European Monetary Union and the implementation of the Maastricht criteria. In 2005, this pact was revised and supplemented. The Stability and Growth Pact requires that the budget deficit of euro zone countries' would not exceed 3 percent and state debt - 60 percent of the country's GDP. For failure to comply with the requirements, the Covenant provides a fine up to 0.2 percent of GDP, if two-thirds of the euro zone finance ministers agree. However, the Pact has been repeatedly violated and the offending party was not penalized i. e. in fact the Pact was not workable.

Since the euro zone debt crisis threatened the survival of the euro zone itself, the European Commission has taken additional measures. In May 2010, the European Financial Stability Fund was set up, - this is a financial company set up by euro zone member states and registered in Luxembourg. The European Financial Stability Fund lends funds to the member states of the euro zone which are in the financial difficulty in line with the agreed terms. In the same year, the European Central Bank approved of the securities market program, which allows for the European Central Bank to buy in securities markets government bonds issued by euro zone countries‘, which are in financial difficulty, or to adopt them as a guarantee when lending money to commercial banks in those countries with a view to maintain their liquidity. The European Central Bank buys government bonds in the secondary markets, because buying government bonds directly from the issuer is prohibited by European Union legislation.

When it became clear that the European Financial Stability Fund was an insufficient measure,

on February 2, 2012, ambassadors of the euro zone in Brussel have signed a new contract. The European Stability mechanism was created using this new contract. The European Stability mechanism is an international financial institution located in Luxembourg, which will provide support for the euro zone countries, when it will be necessary to preserve the financial stability. The European Stability mechanism is a fund created by 17 euro zone countries, the value of which is 700 billion euros. Each of the 17 countries that has adopted the euro will contribute to this fund by providing a certain amount of their capital dependent on the countrys‘ GDP. In essence, the principle of operation of the European Stability mechanism does not differ from the European Financial Stability Fund which provided financial assistance until now, - both of these funds render assistance for problematic countries in the euro zone. The main difference is that the European Financial Stability Fund was created as a temporary fund, that will be abolished on 1 July 2013, while the European Stability mechanism was designed as a permanent institution of the euro zone that could lend to the countries facing financial problems, buying short-term government bonds of these countries.

The euro zone debt crisis is also a banking crisis because banks bought up the largest part of bonds of the crisis countries‘ governments. In order to avoid a banking crisis, restore the trust in them and protect the depositors, the banking system needs more integration in the European Union. The European Commission proposes to establish a European Banking Union consisting of the following main components: to charge the banking supervision function to one institution - the European Central Bank, to create a general bank recovery and restructuring system as well as the deposit protection scheme. The banking union activities should be based on uniform banking regulations. Also, the European Commission proposes to set up an overall bank rescue fund. All of the measures proposed would strengthen the financial stability and positively influence the financial markets.

Where the monetary policy in European Monetary Union undergoes the centralized procedure, with reference to the economic growth prospects of the whole Community rather than separate member states, the fiscal policy is carried out by the national governments independently. On the other hand, the Treaty of Maastricht establishes the requirements for the fiscal policy to be satisfied both by the Euro system member states and the countries pursuing the adoption of the Euro. These requirements are presented in detail in the Stability and Growth Pact that ensures the fiscal policy discipline in European Monetary Union, as well as expresses the principle of sustainability. The latter shall mean that each member state of the Union must maintain a balanced budget over the economic cycle. The permissible national budget deficit of 3 % is allowed during economic recession only. The approval of regulations, established in the Stability and Growth Pact as the basis for the official fiscal policy of European Union, shall mean that the monetary and fiscal policines of the European Union are based on the monetary “fixed-rule” principle, renouncing the Keynesian attitude. Even though such a fiscal policy is based on the operation of automatic stabilizers, it shall not imply that, for instance, in reply to unexpected economic changes, which occur as a result of extraordinary situations, instruments of the discretionary fiscal policy allow for the restoration and maintenance of sustainability of public finances. The fiscal policy might be more effective if it was more centralized and the European Union budget was used for this purpose.

It seems sound to presume that, given the presence of a single currency, we should consider not only the coordination of the monetary policy, but also the enforcement of a single fiscal policy, which, in its turn, requires to have one single treasury, uniform markets for products and services, labour, capital, and other resources, uniform revenue and finance system, as well as one common regulatory mechanism. Such a unitary economic system ought to ensure equal social guarantees for all inhabitants of its member states. Furthermore, the consolidation of markets would also necessitate a closer political integration between countries. Thus, in fact this would be quite a radical solution subsequently leading to a unitary European state. Anyway, the present situation clearly demonstrates that the specific cardinal measures in the economic policy are needed to restore and strengthen the economy of European Union.

5. Conclusions

The presented analysis allows to state that:

1 The establishment of the European Monetary Union was the result of a long-term process of European integration, which had both economic and political goals

2. In the period before the global crisis in euro zone countries, especially in stronger countries, the economies have been growing and strengthened, and the international importance and influence of the euro increased.

3. The global crisis of economy and later the euro zone debt crisis revealed shortcomings of the euro zone and the need for structural changes in this union.

4. The establishment of the financial aid funds to rescue the euro zone countries facing the debt crisis and consolidation of the euro zone banking system likely to cope with the current debt crisis in the euro zone. However, these measures will not solve all structural problems of the euro zone.

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