CHAPTER 5

EUROPEAN MONETARY INTEGRATION

Money is the essence of sovereignty and whoever is responsible for money assumes political leadership.¹

M. Debré

Money asserts power. Next to legislation “nothing [has] greater importance than the designation, value and standard of money”.² Money is also the sinew of war. When asked in 1499 by Louis XII what was needed to take Milan, Condotierre Gian Ciacome de Trivulzio said “three things: money, money, money”.³ Along with power, a great deal of emotionalism is involved in such concepts as national sovereignty and national currency and so since time immemorial, money and all related aspects have been a national concern; the exclusive authority of the sovereign. A successful single market, however, requires monetary integration among its member states, with fixity of exchange rates and the possibility of national currencies eventually being replaced by a common currency; the ultimate goal being complete freedom of movement of goods, services and the factors of production. The founding fathers of the European Community were obviously aware of this fact, however, they chose to ignore it. It is widely held that in the 1950s, monetary integration was not even considered because the international monetary environment was very stable. The gold-exchange standard under the Bretton Woods system consecrated the gold-linked dollar as the world’s

² Jean Bodin (1576), cited in ibid., p.82.
principal reserve instrument and trading currency, exchangeable among central banks at the official IMF rate of exchange. As long as the Member States’ financial interchanges took place with and through a stable dollar, they were not under any kind of pressure to create a European monetary bloc; the dollar provided that monetary integration for the Community. Furthermore, the US financed the major deficit countries of the Community, so, they were not plagued with devaluation, and most of them ran comfortable surpluses and were able to accumulate reserves.

Along with maintaining a stable international monetary environment and providing financial assistance, the US also helped the West Europeans to set up the European Payments Union (EPU). It was aimed at liberalising trade and foreign exchanges in West Europe. The EPU was a central clearing mechanism for trade settlements between OEEC members wherein, within defined limits their currencies were transferable for trade purposes. The Americans hoped that the EPU would be the start of a process towards a common European currency and a European central bank. However, the idea of a common European currency had to be scuttled as during the negotiations itself “the tenacity with which each economy defended its own national interest deprived the EPU agreement of virtually any commitment to the political integration which the US had hoped it would promote”. Britain was identified as the main force behind the sabotage of the American proposal. Britain never felt the need for a Western European Currency Union in order to rebuild their economies in the

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post-War period. It was, however, keen on having a currency union, but only between itself and the US.\footnote{Alan S. Milward, \textit{The European Rescue of the Nation-State} (London: Routledge, 1992), p.350.} It also wanted to abandon the Bretton Woods system of fixed exchange rates and allow the sterling rate to float. In that case, Britain would be second to none but the US and even in that relationship Britain was confident that it would be an equal partner with the floating sterling and force of the Commonwealth backing it. If Britain is guilty of wanting to restore its supremacy in the international monetary scene, then the other West European nations were also not willing to accept the US proposal and undermine their national currencies. As a consequence, the framers of the Treaty of Rome deliberately kept this touchy issue outside the scope of the Treaty.

\textbf{The Treaty of Rome And Monetary Integration}

The Treaty of Rome makes no explicit mention of a monetary integration among the member states. The aspects touched by the Treaty are: (1) Article 2, which calls for economic policy integration by setting the goal of “progressively approximating the economic policies of member states” along with the target of establishing a Common Market.\footnote{ibid., p.351.} In order to promote policy co-ordination, the activities of the Community shall include “the application of procedures by which the economic policies of Member States can be co-ordinated”.\footnote{Article 2, “Treaty Establishing the European Economic Community” (Rome, 1957), \textit{Butterworths Guide to the European Communities} (London: Butterworth, 1992). From now on EEC Treaty.} The particular kind of procedures and the measures to be taken by the Commission to attain the above is sketched loosely in Chapter two on balance of payments, under Title II, Economic policy. Member States

\footnote{Article 3(g), EEC Treaty.}
should "provide for co-operation between their appropriate administrative departments and between their central banks". In order to promote co-ordination of the policies of Member States in the monetary field ... a monetary committee with advisory status is hereby set up”, with the purpose of keeping under review the monetary/financial conditions of the member states and to report to the Commission and to the Council. (2) Each Member State shall treat its policy with regard to rates of exchange as a matter of common concern. (3) Where a Member State is in difficulty or is seriously threatened with difficulties as regards its balance of payments, the Commission shall investigate the position of the State and shall lay down what measures it recommends the State concerned should take. If the actions suggested by the Commission and taken by the State fail to rectify the problem, then the Commission shall, after consulting the Monetary Committee, recommend to the Council the granting of mutual assistance and appropriate methods for the State.

Therefore, the Treaty expressed a desire for policy co-ordination among the Member States but there was hardly any imposing obligations and constraints on the Member States’ national monetary policies. To sum up as Fritz Hellwig, a former member of the Bundestag commented: “the main shortcoming is that there isn’t any binding bias in the treaties for developing a common monetary policy”.

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10 Article 105(1), EEC Treaty.
11 Article 105(2), EEC Treaty.
12 Article 107(1), EEC Treaty.
13 Article 107(2), EEC Treaty.
The 1960s: A Period of Monetary Upheavals

The Bretton Woods system was based on fixed but adjustable parities with the US dollar. The system required each IMF member country to maintain its currency within a band of ±1 percent around the defined bilateral parities. This rule, as a consequence created a currency band twice as wide between two European currencies. In 1958, when the West European countries lifted the restrictions on currency convertibility for transactions related to the current account, the implied maximum allowable fluctuations between any two European countries under the Bretton Woods rules became unacceptable. Therefore, seventeen European countries including the Six, UK, Ireland and Sweden agreed to narrow the margins of fluctuations around the parity value with the US dollar from ±1 percent to ±0.75 percent. This measure constituted a part of an agreement known as the European Monetary Agreement (EMA). In March 1960, the Council of Ministers established a Counter Cyclical Policy Committee, as required by the Treaty, to provide a framework for consultations on counter cyclical policies. It was decided that Member States should inform the Commission of their plans which were likely to affect the economic situation in the other Member States. Soon after the setting up of this committee, in March 1961, the German and Dutch governments revalued their currencies by five percent, without any prior consultations with its partners. This incident convinced the Commission that it had a difficult task at hand; national governments would resist co-ordination of national policies, which amounted to loss of sovereignty. In the Memorandum of the Commission on the Action Programme of the Community for the Second Stage, the

15 For example, if the deutchmark appreciated by 1% against its US dollar parity and, at the same time, the French franc depreciated by 1% against its US dollar parity, the instantaneous depreciation of the French franc against the deutchmark was 2% from the French franc/deutchmark bilateral parity.
Commission called for the co-ordination of counter cyclical and monetary policies among Member States.\textsuperscript{17} The Council and the individual Member States chose not to react to the Commission’s memorandum. Similarly, the Member States diluted the gravity of the subject by concentrating on such matters as co-ordination of structural policies. The question of monetary policy co-ordination was hardly ever raised, and when raised it was in relation to the Community’s Common Agricultural Policy.

In late 1963, Italy was faced with the problem of acute balance of payments depreciation. As per Article 108 of the Treaty of Rome, the Community should have responded in aid of the distressed Member State or Italy should have turned to the Community for help. However, as it turned out, Italy’s first move in her search for a solution to her monetary problem was to seek assistance from the US and not Brussels. “Overnight the President of the Italian Bank of Issue flew off to New York.”\textsuperscript{18} The United States provided Italy support in the foreign exchange market and made loans available from the Export-Import Bank, the Commodity Credit Corporation, and the Federal Reserve Bank of New York, which helped Italy to get over her problems.

One important fall-out of the “Italian Crisis” was the awakening of the Council of Ministers. The Council realised the need for Community action; as a result of which there were a series of developments: first, recommendations were made that any Member State whose balance of payments deficit could not be financed from its own reserves should seek a Community solution in financing that deficit; second, the


\textsuperscript{17} Balassa, n.3, p.176.
Council established a fiscal policy committee “to examine and confront the general lines of fiscal policy” of the Member States and also a committee of the governors of central banks to hold consultations on the general lines of credit policy in the Member States and to regularly exchange information on the measures taken by the individual central banks; and, third, the Council called for advance consultations on matters of international monetary policy and parity changes.¹⁹

At the same time, on the international monetary front, there were major changes. The two reserve currencies – the dollar and the sterling – had gradually started to weaken; the US got more and more embroiled in Vietnam, which forced it to adopt highly expansionary monetary policies at the domestic front. This in turn resulted in an increasing American balance of payments deficit. The end result was that the confidence in the dollar was considerably undermined. Furthermore, in 1968, the US abandoned the gold pool, which had been established with the intention of preventing any increase in price in the gold market, and established a two-tier gold market. This was a clear indication of the inevitable disintegration of the Bretton Woods system.²⁰

Within the EC, the German mark and the Dutch guilder were emerging as strong currencies. This was, to a major extent, because of the domestic policies of the two Member States. Germany, for one, adopted a restrictive monetary policy, which spelled recession. Bonn stressed on exports, while imports decreased considerably; so, whereas German trade balances registered massive surpluses, it had an adverse impact

¹⁹ Balassa, n.3, pp. 177-8.

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Therefore, now the problem was how to share the burden between surplus and deficit countries. The ideal way would have been monetary integration and elimination of balance of payments constraints; however, that was not to be. France wanted an arrangement wherein she could pursue expansionist policies without being constrained by balance of payments deficits. If the Community were to adopt such an arrangement then it implied that Germany also pursue expansionist policies. However, Germany was very particular about price stability and control of inflation. As a result, it resisted any such moves. What ensued was a power struggle within the Community between France, supported by the Commission, Italy, Belgium and Luxembourg, on the one side, and Germany, supported by Netherlands, on the other.

In 1967, three European currencies - sterling, the D-mark, and the French franc - were caught by speculative pressures. The British authorities devalued the pound by 14.3 percent. There were speculations that the French franc would also be devalued and the D-mark revalued to establish equilibrium in the balance of payments. However, the two key Member States of the EC resorted to unilateral measures. While Germany applied taxes on exports and rebates on imports at the rate of four percent and imposed limitations on foreign deposits, France introduced exchange controls, applied import quotas on commodities representing about one-fifths of its imports from EC member countries, and provided subsidies to exports. In spite of all the Council resolutions and decisions that Member States must co-ordinate their national

23 Balassa, n.3, p.179.
economic and monetary policies, there was no way the Member States would give up that right. There was no political will to pursue co-ordination seriously. This was to be the main hindrance to all Community attempts at monetary integration that followed.

The Barre Plan: The First Concrete Attempt At Monetary Integration

Against the background of an unstable international monetary environment, and lack of co-ordination among the Member States within the Community, the first concrete action on monetary integration in the shape of the Barre Plan emerged. During a meeting of the Council of Finance Ministers on 26-27 February 1968, Raymond Barre of France proposed a “Monetary Plan of Action for the Community” with specific focus on: prior mutual consent with respect to adjustment of exchange rates; elimination of fluctuation margins; establishment of a system of mutual assistance; and establishment of a single European unit of account.24

A monetary committee was set up to study these proposals. In the course of these discussions, there emerged two camps - the “monetarists” and the “economists”. The “monetarists” - France, Belgium and Luxembourg - were influenced by the Barre Plan and believed that the first step in a monetary arrangement was permanent fixing of exchange rates. This would then force a common monetary policy and thereby pave the road to monetary union.25 They also expected to pass the adjustment burden to the surplus countries and thus face them with the choice of either financing the deficits of others or accepting a higher rate of inflation. This is precisely what the surplus countries or the “economists” wanted to avoid. The Germans and the Dutch, who

24 Szasz, n.22, pp. 11-12.
25 Jürgen Schröder, “European Monetary Integration: Problems and Perspectives”, in H. S. Chopra, Robert Frank and Jürgen Schröder, eds., National Identity and Regional Cooperation: Experiences of
comprised the “economists”, argued that first there should be complete monetary coordination then a permanent fixing of the exchange rates and from this would follow a currency union with a common central bank. According to Professor Tsoukalis, this difference between the two groups was nothing but “an ideological cloak for different short term interests of individual countries”.26 The “short-termism” of some of the Member States became clearer through their subsequent actions. The Germans and the Dutch made it very clear that the Barre Plan’s one-sided monetary approach was not acceptable to them. Subsequently, when the committee came out with its interim report, it resonated with this very sentiment of the Germans and the Dutch: “there is ... no reason to believe that progress in co-ordination confined to the monetary sector will be sufficient or even possible if not accompanied by progress in other sectors”.27 At the same time, confidence in the dollar had reached an all time low. All around countries were converting their dollar reserves to gold, which put immense pressure on the US. President de Gaulle of France considered this an opportune moment to successfully confront the US. However, he did realise that it would be impossible to do it alone and so from then on de Gaulle pressed for the EC countries to act in unison and called for co-ordination of their views and actions in the international monetary discussions. The other Member States also wanted a system where they would no longer be dependent on the US for the supply of reserves. However, on what this system should be like, none were clear. Germany realised that it was indebted to the

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27 Cited in Szasz, n.20, p.12.
US and could not freely convert its dollar reserves to gold as France had done. This simply aggravated the already existing rift between France and Germany. But, the final blow came in May 1968, when due to serious exchange rate tensions, there was considerable pressure on France to devalue. France realised that the only way out was the simultaneous revaluation of the D-mark and a devaluation of the franc; however, Germany refused to revalue its currency for fear of “strangling the economic upswing that was taking place and that it would merely be a concession to de Gaulle’s nationalist sensitivities”. Even though de Gaulle had no option but to devalue the franc, he refused to devalue and maintained an artificial situation in the name of national pride. Finally, in 1969, when de Gaulle resigned, President Pompidou devalued the franc and subsequently Germany also revalued its D-mark. However, the relations between the two had touched an all-time low and showed no signs of improvement.

The Werner Plan: The Second Attempt At Monetary Integration

The 1969 Hague Summit is a milestone of sorts in the history of the EC. It drafted those three crucial words - completing, deepening and widening - that went on to make radical changes in the Community building process. It was also at The Hague that the Member States expressed their desire to proceed to a monetary union; and for the first time monetary integration was explicitly adopted by the Community.

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28 Germany was caught in a delicate situation as politically it was dependent on the US for guaranteeing the freedom of West Berlin and it was the presence of the American military in the Federal Republic that provided for its security. So, Germany could not really exploit the weakness caused by the US balance of payments deficits as a part of this deficit was due to America’s military expenditure abroad.

29 Szasz, n.20, p.24.

Accordingly, a committee was appointed under the chairmanship of Mr. P. Werner, the Prime Minister of Luxembourg, to prepare a report on the monetary union to be undertaken by the Community. In October 1970, the Werner Report was made public. It recommended a step-by-step approach to an economic and monetary union. It was to be in three stages starting in 1971 and ending approximately ten years later. As the starting point, the Report identified "the absence of sufficient co-ordination of economic and monetary policies" and the lack of "common positions" in the international monetary relations as the main drawback of the Community, which had to be rectified.31 The final objective, i.e. a monetary union was defined by the Report as "a monetary union implies inside its boundaries the total and irreversible convertibility of currencies, the elimination of margins of fluctuations in exchange rates, the irrevocable fixing of parity and the complete liberation of movements of capital."32 The maintenance of national monetary symbols or the establishment of a sole Community currency may accompany it. For such a monetary union, "transfers of responsibility from the national to the Community plane will be essential"; "the principal decisions in the matter of monetary policy should be centralised"; and most importantly there has to be institutional reforms. Werner suggested the creation of the centre of decision of economic policy, which would take over the responsibilities exercised by national authorities until then. This transfer would go hand-in-hand with the transfer of a corresponding parliamentary responsibility from the national plane to the Community’s European Parliament. Finally, the Community must constitute a Community system of central banks, which would have power to take decisions in the

31 "Report to the Council and the Commission on the Realisation by Stages of Economic and Monetary Union in the Community" [Werner Report], October 1970, ibid., p.111-12.
matter of internal monetary policy as well as to intervene in the foreign exchange market and management of the monetary reserves of the Community.\textsuperscript{33}

The Werner Report had a federalist ring to it, especially in its call for establishing the centre of decision. This was not approved by some Member States, especially France, which forced the Commission to delete the term, 'the centre of decision' from the Report. The Germans, on the other hand, feared that whereas they would be financially committed to monetary union, there might not actually be any progress towards a monetary union. As a consequence, Germany insisted on the inclusion of a safeguard clause that the provisions on reductions in the margin of fluctuation among Common Market currencies would lapse if by 1975 there was no agreement on the measure of policy co-ordination to be taken in the second stage.

As it turned out, the first stage of the Werner Plan was not implemented immediately. It is widely held that the delay was due to the highly unstable international monetary conditions prevailing at that time.\textsuperscript{34} The first stage involved the exchange rate fluctuations between Community currencies to be held within margins narrower than those resulting from the application of the margins in force for the dollar.\textsuperscript{35} This move was opposed by the Dutch on the ground that the narrowing of margins would merely limit the scope for interest rate differences between Member States and thus hamper

\begin{footnotes}
\item[32] ibid., p.112.
\item[33] ibid., pp. 113-16.
\item[34] Hitiris and Zervyianni, n. 19, p.134.
\item[35] When depicted in a graph, this narrow band writhed like a snake through a wider band, or tunnel, observed against the dollar. Hence the arrangement came to be known as 'the snake in the tunnel' or just 'the snake'.
\end{footnotes}
monetary policies. However, the Dutch were alone in their opposition. Even as the discussions to narrow the fluctuation bands between EC currencies were going on, the German members of the Monetary Committee indicated that Germany would have to stop interventions in the exchange markets in order to stem the capital inflows that bloated domestic liquidity. On 9 May 1971, Germany went ahead and floated the D-mark on its own; the Netherlands also followed. Three months later the US announced its decision to terminate the dollar’s convertibility into gold.

In the ensuing unstable international conditions, the Community presented a picture of disunity. For Germany, the appreciation of the D-mark against the dollar meant its competitive position was affected. To do away with this unfavourable impact, joint floating of the D-mark with its main trading partners, i.e. Community currencies, would have been the answer. Therefore, Germany tried hard to persuade its Community partners to jointly float their currencies. However, for others like France and Italy, joint floating would have meant deterioration of their competitive positions due to the D-mark’s strength and so they refused joint floating. A semblance of stability was established in the international monetary scene in December 1971 when the Smithsonian arrangement was agreed, which established a bandwidth around the dollar from ± 0.75 percent to ± 4.5 percent. Once this was done, the Community members showed interest in embarking on the Werner Plan. However, the more important reason was that Germany, under its new leader, Willy Brandt, was following its own agenda. Germany made great progress in its relations with the Soviet Union and East Europe. Most importantly, Brandt represented that face of the

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36 Nothing came of the Dutch opposition, implying that unless the leading two - Germany and France - demanded a change, there would be no change.
new Germany, where they were no longer apologetic for their actions in the past. Brandt did not feel the need to consult anyone or seek permission from anyone. Therefore, the Community, especially France was determined to link Germany to Europe in such a way that it could no longer cut loose. And, the means suggested to and accepted by Brandt was monetary integration. Thus, the first Community arrangement in the form of the ‘Snake’ took shape on 10 April 1972.

The “Snake”
The “Snake” was an arrangement whereby the Member States of the EC together with Britain, Ireland, Denmark and Norway decided to peg their currencies to each other with a bandwidth of ± 2.25 percent, i.e. half the bandwidth of the Smithsonian agreement, within the tunnel, i.e. the margin each participating European country observed between its currency and the US dollar. However, soon enough the “Snake” ran into problems. First of all, the US decided on 19 March 1973 to let the dollar float and so the tunnel ceased to exist for the snake. The same year, the oil crisis hit and it affected the Member States quite adversely. Inflation rates soared and one by one Member States were forced to leave the “Snake”.

Once the dollar was allowed to float, in March 1973, the Member States considered floating jointly against the dollar; however, Britain set conditions, like interest free credit for unlimited amounts and unlimited duration, in return for its participation. The others considered this as a British attempt to disguise a refusal. Italy too tried to weaken the settlement arrangements. The biggest blow, however, was the French

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withdrawal as it undermined the Community nature of the “Snake”. France rejoined in July 1974 but soon suffered deterioration in its current account of its balance of payments and had to leave the “Snake” for good. Finally, the “Snake” was reduced to a D-mark currency zone consisting of Germany, the Benelux countries and Denmark.

There was a debate within the Community on the question of proceeding to the second stage of the monetary union. Considering the plight of the first stage, it was a little absurd, however, it was agreed that the Community could, from the beginning of 1974, proceed to ‘a’ second stage of the monetary union. The word ‘the’ was deliberately omitted. However, nothing much came of it and it was clear that having a currency union by 1980 was infeasible and so the Werner Plan was formally abandoned.

In the final analysis - why did the monetary union as envisaged by Werner collapse? The turmoil in the international monetary environment caused by the dollar, is the oft-cited reason, but it must be noted that the endeavour of monetary integration was undertaken precisely to counter the instability caused by the dollar. The other reason given is the oil crisis. However, the first oil price rise did not occur until October 1973 and it took time to feed into the system. By then the Community’s attempt had already failed. Though one cannot rule out these factors, it is clear that the underlying factor responsible for the failure of the monetary union was the failure on the part of the Member States to coordinate their policies. There was no political will to back the

39 June 1972, the Sterling and the punt left; the Danish krone followed but subsequently returned to the fold; 12 February 1973, the lira was floated and stayed out; and in 19 January 1974 France was forced out.

monetary union. Their short-term interests did not include co-ordination of national policies; and national sovereignty was zealously guarded.

The European Monetary System

Though EMU as envisaged by Werner was officially abandoned, the spirit of the monetary integration enthusiasts was not dampened. Numerous plans were put forward to revive efforts towards EMU (The Fourcade proposal in December 1974, the Marjolin Report in March 1975, the Tindemanns Report in December 1975, the Duisenberg proposal in 1976, the Ortoli and Jenkins proposals in September 1977 and the Commission's own proposal in November 1977). James Callaghan, the British Prime Minister, also felt the need to address the problem and put forward a five-point proposal, which would not be limited to Europe alone but would help to successfully approach the problems faced by the international economic system. In short he proposed an arrangement which included the United States as well. However, none of these proposals got the support of the leading EC governments.

Germany was in favour of a European approach and did not care for an arrangement with the United States. This was because Germany was disenchanted with the US for not taking appropriate measures to control the downslide of the dollar. As the dollar declined, the D-Mark appreciated, which in turn squeezed industrial profits and discouraged investment in Germany, making expansion very difficult. Similarly, when the dollar declined, switching funds into the D-Mark became common and increased the trend towards using it for reserves and trading purposes. So, Germany was keen on

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40 The emphasis of this five-point proposal was on generating higher economic growth. It included energy policies to conserve supplies, expansion of trade to help guard against protectionism, and an increase in capital flows to developing countries. Currency stability would be promoted within the
breaking up with the US and believed that Europe should start taking care of its own interests. As a consequence, Herr Schmidt had a meeting with President Giscard d'Estaing to find out if France would be interested in coming back to the "Snake". Giscard d'Estaing was keen on being part of a "zone of monetary stability" but was not very happy to return to the "Snake", from which it had been forced to leave twice. In Otmar Emminger's words, "when France left for the second time in 1976, it was clear that it would be most unlikely to rejoin the 'Snake' a third time. There was a distinct feeling that something else would have to be created". On 7 April 1978 at the meeting of the European Council in Copenhagen, Schmidt proposed a Franco-German initiative for monetary integration. It was a German proposal, to which France gave its unconditional support. Now, what was in it for France to have blindly endorsed the European Monetary System? First of all, France was happy to take advantage of the German disenchantment with the US. France viewed this as an opportunity to promote a European policy, which would give Europe independence from the dollar. Secondly, France wanted to share the leadership of Europe with Germany, "partly from national pride and partly from fear of German dominance if France did not keep pace". But, most importantly, it served the short-term interest of France i.e. the French Prime Minister, Raymond Barre, hoped to make French industry a major competitor on the world market. For this the government required a stable franc, control on the growth of money supply, wage rise and budget deficit. President d'Estaing viewed the EMS, and the accompanying discipline it would bring,
to be complementary to the Barre Plan. As a result, d'Estaing whole-heartedly supported Schmidt with his EMS proposal.

At the meeting of the Heads of States and Governments of the European Community, at Bremen, on 7 July 1978, the EMS as envisaged by Germany was presented. This EMS proposal looked "rather like a modified version of the old Snake". The broad principles of the proposed EMS were: (1) facilitate the interdependence of European economies by providing a tool for exchange rate stabilisation and for encouraging convergence of economic and monetary policies. The tool proposed, known as the Exchange Rate Mechanism (EMS), consists of four components – (a) the ecu, to be created initially against the transfer of 20 percent of the gold and dollar reserves of members and valued against a basket of currencies of member states; (b) the parity grid with features of the basket added to it, i.e., every currency would be tied to every other currency in a system of mutually agreed cross rates and also tied to the ecu; (c) the divergence indicator, which would give a country a warning when its currency neared the divergence of the ecu central rate; and, finally, (d) the availability of credit financing – the Very Short Term Financing Facility (VSTF), the Short Term Monetary Support (STMS) – to be administered by the central banks – and, the Medium Term Financial Assistance (MFTA) – to be administered by the Council of Ministers. (2) The creation of the European Monetary Fund (EMF), intended to pool under its authority a portion of the gold and dollar reserves of member countries, in return of

44 The Economist, 7 October 1978, p.65.
deposits in the EMF, denominated in ecus and to be used in settlement of intra-EEC
debt.47 (3) Carry out “concurrent studies” of action that might be needed to strengthen
the economies of the less prosperous countries.48

What followed since these proposals were presented was a series of negotiations,
bargaining and a cold calculation of national interest among the Member States. To
begin with the EMS was entirely a German proposal which France agreed to support;
and so was presented as a Franco-German initiative. All the deliberations carried out
were in secret between the two until the European Council meet in Copenhagen. EMS
was designed in such a fashion that it would be a monetary arrangement that could be
brought within the ambit of the Community’s institutions; where monetary issues
would also become a part of the Community’s horse-trading game. Whereas Germany
wanted monetary integration to help it bring its economic weight to bear
diplomatically, France wanted EMS to give economic muscle to its diplomatic
ambitions.49

For Germany, the removal of uncertainty about currency value meant offsetting the
comparative advance in the US over Germany in trade with the other members of the
EC, and a fixed exchange rate among Community countries meant the speculative
pressure would be off the D-Mark. Speculators would find other EC currencies

47 Geoffrey E. Wood, “The European Monetary System – Past Developments, Future Prospects and


49 Bernard Connolly, The Rotten Heart of Europe: The Dirty War for European Money (London: Faber
equally attractive, which meant removal of funds that would flow into the D-Mark.\textsuperscript{50} France, the Benelux countries and Italy chose not to differ with Germany over the EMS proposal; however, Britain's reaction was negative. This had two consequences – one, the other Member States became suspicious of British intentions, and two, Britain was alone in opposing the EMS.

Though Britain's main objection was that the EMS was a purely European arrangement, which excluded the dollar entirely, Britain also had reservations on various other aspects of the EMS. Firstly, Britain was opposed to the parity grid system as, under this arrangement, whenever exchange rates divergence occurred, two currencies always reached their intervention margins at the same time, even if the divergence were caused by a strong currency rising in value. It put pressure on the weaker currencies to continually keep up with the currency at the top. But, in case of a basket arrangement, this would not happen. The stronger currency would be forced to adopt policies of internal monetary expansion or capital exports. The D-Mark being the strongest currency in the Community would have come under such pressure, and so the Bundesbank opposed the basket system.\textsuperscript{51} Britain got the support of other weak currency Member States like Italy over this issue; however, before Britain could mobilise further, Herr Schmidt had another private meeting with President d'Estaing and extracted a commitment that the Community would abide by the Belgian Compromise.\textsuperscript{52} And so, at the meeting of the Finance Ministers, the German formula


\textsuperscript{51} The Economist, "Seven Summits to a Super snake". \textit{The Economist}, 21 October 1978, p.58.

\textsuperscript{52} The Belgian Compromise accepted that the parity grid be used for intervention, but the basket could rattle to indicate which currency is really out of line as a guide to changes needed in national economic policy.
came to be adopted. Secondly, Britain felt that under the EMS, exchange rates were allowed to change too easily. Britain argued that parities should be kept in line by the pursuit of appropriate economic policies and there should be symmetry of pressure on both strong currency countries to reflate and on weak currency countries to deflate. Britain wanted this symmetry to be built into the system.\textsuperscript{53} Thirdly, if the Community was not willing to first increase growth and reduce inflation before embarking on the EMS, then provisions must be made which would enable the weak currency Member States to bring about convergence of economic performance. On this point, Britain had the support of Italy and Ireland.

Italy preferred a looser arrangement, which would allow wider margins of fluctuation, i.e. more than 2.25 percent for all currencies, not just the lira. Further, Italy expected a guarantee that it would be easy to change the basic exchange rates before speculation started and wanted a promise of new cash transfers, well above the offers made by France and Germany.\textsuperscript{54} Ireland, on the other hand, was keen to join the EMS. Just like the French, Ireland also saw the economic discipline accompanying the EMS as an impetus to the ongoing economic reforms in the country. Moreover, the side-payments involved were more than welcome. But, most importantly, being a part of the EMS meant a break from relying solely on Britain. Therefore, joining the EMS was not the issue for Ireland, but how much it could get from the Community in the form of side-payments was. Ireland held that it would need a grant of 650 million pounds over the first five years to help it adjust.\textsuperscript{55} At the Bremen Summit, Germany had offered Ireland

\textsuperscript{53} Taylor, n. 45, pp 184-5.
\textsuperscript{54} The Economist, “As Ireland Stakes its Shirts on EMS, Italy Wants Shorter Odds”, \textit{The Economist}, 4 November 1978, p. 52.
\textsuperscript{55} ibid, p.52.
625 million pounds as a one-off soft loan at 2.5 percent interest rate, however, Ireland did not consider this adequate enough.

At the Brussels Summit held on 4-5 December 1978, Germany proposed for the poorer Member States – 1) extra loans from the European Investment Bank (EIB) spread over three years, 2) interest rebates of 3 percent on EEC loans, financed from the EEC budget. Italy would get 60 percent, Ireland 20 percent and Britain 20 percent if it joined the ERM, and, 3) a special new section of the regional fund, spread over three years of which Italy would get 50 percent, Ireland 30 percent and Britain 20 percent. However, France did a volte face at Brussels. During the negotiations on the regional fund, the European Parliament proposed a two-third rise in the fund for the following year. France was not pleased with the proposal, however, it put forward a condition for agreeing – an increase in France’s quota in the regional fund. But, it was rejected. Therefore, France vetoed any increase in the fund and the creation of the special section for Italy, Ireland and Britain. Similarly, on the second component, i.e. loans, France said the maximum that could be offered was extra loans of 1000 million ecus ($1.3 billion) per year plus 200 million ecus ($260 million) per year in interest rate rebates. Of this, two-thirds would go to Italy and one-thirds to Ireland. Suddenly, Italy and Ireland were no longer keen to be part of the EMS. They left Brussels saying they would have to reconsider their positions. Britain, on the other hand, was happy that it would not be singled out for being a spoilsport; France would share the blame. If Italy, Ireland and Britain were to stay away from the EMS, then it would be lacking

57 The Economist, “Then there were Six”, The Economist, 9 December 1978, p.17.
58 ibid.
a Community nature, but France dismissed it as "[then] it might simply be an inter-
governmental deal like the present snake". 60

Whereas Italy and Ireland were concerned only with the issue of side-payments, 
Britain considered it a marginal issue. If the scale of the regional fund or the 
Investment Bank was increased, then Britain would have been a major beneficiary. 
Though such receipts were welcomed by Britain, it continued to focus and stress on its 
short-term interest, i.e., reducing its contribution to the Community budget, implying 
that the CAP be reformed as the CAP dominated the EC budget. Since the number of 
farmers in Britain is much less compared to the rest of the Community, the benefits 
coming Britain’s way was proportionately less. Similarly, because Britain was not an 
exporter of food, it did not receive Community support by way of export subsidies. 
Therefore, Britain insisted that this budgetary imbalance be corrected. However, the 
other Member States were not ready to accept this condition. And therefore, Britain 
chose to stay out of the EMS. On the other hand, President Andreotti of Italy was 
forced to opt in favour of the EMS in spite of the 'Brussels dud' 61 as the small parties 
supporting the government in his country, threatened to withdraw support if he opted 
otherwise. 62 So, Italy immediately joined the EMS. In the case of Ireland, Mr Jack 
Lynch was able to negotiate for additional bilateral loans from the richer Member 
States – Germany, France and Denmark; and also obtained sufficient concessions to 
offset the costs of breaking with the pound sterling. Thus, Ireland also joined the 
EMS.

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59 ibid.
60 ibid.
With Ireland and Italy being part of the EMS, it was decided that the EMS be set up as a Community system, and not merely by agreement between governments. The EMS was to come into effect on 1 January 1979. However, the biggest blow to the hitherto slow and torturous EMS negotiations came on 20 December 1978, when the Community Agricultural Ministers came together to decide the fate of the Monetary Compensatory Amounts (MCAs). The Commission suggested that new MCAs be established but be worth the same as the old ones and measured in ecus. France suddenly turned awkward and blocked all such changes. It demanded a phasing out of all MCAs, i.e. have just one EC price level for all Member States. If MCAs were abolished, the Germans would have to cut their high farm prices and Britain would have to raise their food prices. When farm prices increased, the cash transfers from food importing countries, such as Britain and Germany, to food exporting countries, such as France, would also increase. Each one percent farm price increase would cost Britain some 10 million pounds and benefit France by the same amount. If all MCAs were abolished, average farm support for EEC prices would rise by ten percent and so France made this a condition for the French green signal for the commencement of the EMS. This uncompromising pursuit of national self-interest was similar to the 1965 “empty chair” crisis when France had kept itself away from attending EC meetings for seven months.

63 The end of the Snake meant the end of MCAs too as MCAs were calculated with reference to the Snake.
The EMS: An Assessment

The deadlock created by the French stance was resolved by the 'Gentleman’s Agreement' and the EMS became operational. Looking back at the EMS years it is clear that the EMS did not merely survive but steadily gained in reputation too. The exchange rate fluctuations were brought under control, there was convergence of national inflation rates, and most importantly, there was an increasing trend of collective decisions being taken. This was observed especially in the case of the twelve realignments that took place between 1979 and 1990. The purpose of the study, however, is not to assess the stability or achievements of the EMS but to examine what the Member States’ perceived interests from the EMS were and how they behaved in order to achieve those interests. It is, of course, difficult to identify the positions taken by individual countries. There is always a continuous evolution of economic thinking and political moves and therefore, Member States’ attitudes may not necessarily be homogeneous and constant all the time. Nevertheless, an attempt is made below to characterise their attitudes vis-a-vis their national interests.

On the one side there was Germany and on the other the rest of the Community. Germany was the undisputed economic giant within the Community, with the Bundesbank as the dominant central bank and the D-Mark as the anchor currency in

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65 The agreement was that MCAs would be reduced and eventually eliminated, however, it would be ensured that the domestic farm prices would not fall. See Ronald I. McKinnon and K. C. Fung, "Floating Exchange Rates and the New Interbloc Protectionism: Tariffs versus Quotas", in Dominick Salvatore, ed., Protectionism and World Welfare (Cambridge: Cambridge University Press, 1993), p.233.


the EMS. In the past there were hegemonic states. Therefore, the world money was always simultaneously a national currency, e.g. the British pound sterling and later the US dollar. This duality had engendered tensions, unjust national advantages and crisis. From this angle, the EMS was different. There was to be no hegemone but an arrangement among several parties of equal rank. However, very soon the D-Mark assumed the role of the dominant currency in the EMS. If any currency came under downward pressure it became particularly important if its cross rate against the D-Mark pressed against the ERM limit. As a result, currencies such as the Belgian franc were kept within even narrower bands around the D-Mark central rate than the rules of the system demanded. Throughout the EMS years, there were twelve realignments, but the D-Mark was never once devalued. The Bundesbank made it clear that its first and only obligation was to preserve the stability of its own currency. So, an expansionary monetary policy to accommodate the rest of the Community was out of the question and the only alternative was to persuade the other countries to adopt a more stability-oriented policy. As a consequence the strict Bundesbank style measures were imposed on the rest of the Community. It has to be said, however, on Germany's behalf that it never overtly aspired to become the monetary giant in Europe. In fact, it always insisted on a Community approach to the monetary problems faced by Europe. As a former German Chancellor, Helmut Schmidt, says: "The progress made in European integration ... corresponds to Germany's vital, long-term strategic interest in ensuring peace if our country wishes to avoid a third anti-German


69 Bernholz, n. 14, p. 752.
coalition. All Chancellors from Adenaur to Kohl have been guided by this insight ...
Compared with this essential goal, all the nit-picking about the technical details of 
monetary union ... is of secondary importance".\textsuperscript{70} Therefore, "despite having all [the] 
solid components of power, Germany took care not to become heady, and has 
displayed great reluctance and restraint in the exercise of that power and influence or 
in throwing its weight around".\textsuperscript{71} However, German monetary strength and power was 
there for all to see. They very tactfully coaxed the other Community members to adopt 
the EMS; and the Bundesbank practically assumed the role of setting monetary policy 
within West Europe. This arrangement suited all Member States, though they might 
not have liked it. There was at least a semblance of equality among the Member 
States, with decisions taken after rigorous negotiations, although ultimately the 
Bundesbank's wishes became the command. As Erik Hoffmeyer, a Danish central 
banker said, it was better to have a voice, even if only one among twelve, in the 
setting of a common European monetary policy than have the Bundesbank alone 
speak for everybody.\textsuperscript{72} At the same time, the Bundesbank's strict policy regime 
unleashed deflation and recession across the Community. But the Bundesbank 
continued to maintain that controlling unemployment in the Community was not its 
problem. Moreover, the Bundesbank's strict control on inflation seemed to suggest 
that if Member States wished to compete and avoid realignments then they had to 

\textsuperscript{70} Ibid., p. 734.
accommodate themselves to the German rate of inflation and the German monetary stance.\(^73\)

This dominance of the D-Mark within the EMS also caused a certain asymmetry in the system. The asymmetry manifested in two ways: 1) the system relied heavily on intra-marginal interventions. It undermined the system and affected the other Member States adversely. The dependence on intra-marginal interventions led to excessive burden on the central bank defending the weak currency. This was because, whenever realignment pressures were felt, the interest rates paid on the weak currencies would rise very sharply while the D-Mark rates edged only fractionally lower.\(^74\) Furthermore, the very short-term credit facility, which could be triggered automatically, only as a result of marginal interventions, fell increasingly into disuse.\(^75\) Similarly, the threshold of the divergence indicator was rarely reached.\(^76\) 2) “A country which is competitive vis-à-vis Germany at the time it pegs its currency will become more and more uncompetitive as long as its inflation rate exceeds that of Germany. So when its inflation rate ultimately converges, its price level will be too high: a situation which can only be corrected by a subsequent period of inflation below that in Germany”.\(^77\) This was particularly tough on the rest of the Community. They had to suffer the high cost of unemployment and loss of output during the transition. And, this brought Member States like France and Italy in direct contention with Germany. As long as

\(^{73}\) Swann, n.39, p.231.

\(^{74}\) Minikin, n.68, p. 26.

\(^{75}\) Tsoukalis, n.26, p. 179.


their inflation rates and exchange rates were out of control, they found it favourable to link themselves with the D-Mark, but once Europe started to enjoy exchange rate stability and convergence of inflation rates, these member states were no longer willing to accept the D-Mark supremacy and the accompanying asymmetry. France and Italy exerted strong pressures to correct this asymmetry and thus ease the economic ills they had to endure. Their pressure resulted in the Basle-Nyborg Agreement in September 1987. At the same time, these member states also realised that reduction in their inflation rates by itself would not establish credibility of their policy-making authority. It was the stability provided by the D-Mark and the strict rules of the Bundesbank that lent them credibility. So, they were also clear that they could not abandon the EMS as that meant they would lose whatever credibility they were enjoying.

In fact, France, in order to build a reputation for sound money adopted the *franc fort* policy, i.e., shadowing of German interest rate policy; in return it was willing to accept higher rate of unemployment and incur the resulting fiscal and social costs. France also harboured another desire – to control Germany, its economy, its monetary policy and in the process the monetary policy of the Community. As a result, the French insisted on the creation of a European Monetary Fund (EMF). Gradually the French technocrats could gain control over the monetary policy of Europe. As a

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78 The Agreement was aimed at a partial correction of the asymmetry in the EMS. It was agreed that (1) loans of EC currencies would be made available through the EMCF for the financing of intramarginal interventions, (2) the very short-term credit facility would be extended, ecus would be used for the settlement of debts and the central bankers intended to achieve a closer co-ordination of interest rates, (3) make realignments of central parities as infrequent and as small as possible, and (4) expressed their intention not to compensate fully for inflation differentials.

79 McDonald and Zis, n. 66, p.189.

80 Simon Bulmer and William E. Paterson, “Germany in the European Union: Gentle Giant or Emergent
former President of the Bundesbank, said, if the EMF is established, “we would not be dealing with M. Giscard d'Estaing but with the French bureaucracy. And if there is one thing I admire it is the French bureaucracy: it has been trained to the highest level by centuries of experience and is vastly superior to us in the diplomatic pursuit of national interest”. As it turned out, the biggest weakness of the EMS was the non-establishment of the EMF. The internal power struggle killed any initiative. Germany and France could not reach a consensus over the role of the EMF, its accountability and its independence.

For the smaller economies such as Belgium, Denmark, Ireland and the Netherlands, it was an accepted fact that they needed EMS for its disciplinary impact on their economies. Moreover, for these economies intra-European trade, accounts for a sizeable proportion of their GDP; and so, a stable exchange rate environment was important for them. Therefore, EMS had their full support but that did not mean that they complied de facto with all the rules required for complete exchange rate and monetary union. They have blocked the full integration of their financial asset markets with those abroad and directed their monetary policies to the pursuit of purely domestic objectives. They have also resorted to sterilisation of undesired liquidity effects from exchange-market intervention, imposed restrictions on capital movements and handled domestic credit controls in a selective manner.

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82 Cobham, n. 76, p. 209.
Greece, Spain, Portugal and Ireland, which had underdeveloped financial sectors, had a high degree of control over capital movements. France, however, had the most extensive controls on capital. The French were not allowed to hold bank accounts abroad, they required permission to open foreign currency accounts in French banks and there were limitations on French banks lending to non-residents. Similarily, Belgium blocked capital movements by means of a dual exchange rate system.

Monetary arrangement of any sort requires political integration, which is possible only if the Member States are prepared to abandon to a significant degree their separate macro-economic policies. Apart from a general agreement in favour of convergence of inflation rates and to maintain stable exchange rates, there was no political will to harmonise the Member states’ macro-economic policies. This was mainly because of the unwillingness to cede sovereignty over monetary matters. So then, how is it that the EMS survived? The choice before the EMS Member States was to either accommodate the German monetary policy perfectly or bear the burden entirely. They could get temporary respite by resorting to periodical realignments. The member states chose to adhere to the German policy, albeit grudgingly, and the EMS was successful in maintaining a stable monetary environment in the 1980s.

EMS to EMU
As explained above, the EMS succeeded in establishing a zone of monetary stability in the 1980s. However, by the end of the decade numerous changes took place and the system could not cope with the underlying economic realities. The Single European Act (SEA) recognised the need for convergence of macroeconomic policies and

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introduced a chapter on Cooperation in Economic and Monetary Policy (Economic and Monetary Union). For the first time economic and monetary union was explicitly mentioned, in a Treaty, as a policy objective to be pursued by the member states. The SEA paved the way for the Single Market Programme; and the Single Market heightened the enthusiasm for a single European currency, especially among the business class. In 1983, France under the Presidentship of Francois Mitterrand underwent a complete change with respect to its European policy. Mitterrand became the champion of economic and monetary union in the Community. Shortly, Jacques Delors was appointed the President of the Commission. The Delors Commission turned out to be a very powerful one and it proved that the member states could appoint a powerful Commission when they so decide.

By early 1988, Germany began to "gear up to act as the federator of the Community". The Bundesbank became Europe’s de facto central bank, and the principal counterpart of the Federal Reserve Bank in managing the Dollar–D-Mark rate. The Community partners had to gauge their exchange rates and monetary policies on the D-Mark. The Bundesbank also opposed the development of the ecu on the ground that as an index of currencies, it was softer than the D-Mark. The German government and the Bundesbank seemed to suggest to their partners that they had a

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choice between accepting Germany's unilateral decisions or multilateralising them on Frankfurt's conditions.

France, Italy and Spain resisted the Bundesbank's hegemony while drawing on its authority to contain inflationary pressures in their own economies. They sought an alliance with the United States to counter German hegemony, which was forged at the meetings of the G-5 Finance Ministers in New York in 1985 and again in the Louvre in 1987. The US lowered the dollar against the D-Mark and it prompted an expansion of international liquidities.\(^9\) Subsequently, at Nyborg the Bundesbank was forced to agree to intervene in the foreign exchange markets to sustain weaker ERM currencies.

All the above-mentioned factors played a role in paving the way for the EMU. However, the most important factor was the German re-unification. In West Germany, the impact of re-unification were the opening of new markets for West German exports, heavy immigration from East Germany, and massive public transfer payments to the new eastern Länder.\(^9\) With the West pumping in resources to the eastern part, the German long-term rate began to rise by mid-1989. Investments grew strongly in Germany through 1991-92, at a time when investments outside of Germany had touched negative.\(^9\) At the same time, the one-to-one conversion of East German wages and the subsequent wage bargains in East Germany raised the cost and price of

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\(^9\) Ibid., 330.


East German output and reduced its quantity. In order to counter this supply shock there were huge transfers made from the west into the east, financed by an increase in the German public sector deficit. As a result, real interest rates in Germany rose and the German capital account swung from the net capital export of D-Mark 135 billion in 1989 to a net capital import of D-Mark 107 billion in 1992. The combined effect of the supply shock and the demand shock was the real D-Mark appreciation.\textsuperscript{93} The D-Mark appreciated in real effective terms by about 8 percent from late 1989 to late 1990 and by August 1992 it was some 10 percent above its late 1998 level.\textsuperscript{94} 

Since the central rates in the ERM were not adjusted in 1990-91, the real D-Mark appreciation had to take the form of higher inflation in Germany and lower inflation in the other ERM countries. And, since the other ERM currencies were linked to the D-Mark, the impact of these developments in Germany was transmitted completely to the rest of the Community. The weaker currencies became grossly overvalued because of the real D-Mark appreciation; and the ERM members also had to hold their interest rates high, as the German rates were high. This was at a time when the investment boom was only in Germany, the other member states were experiencing negative investment. As a result, many economies were in "free fall".\textsuperscript{95} Italy and the UK suffered the severest stabilisation crisis. The UK had only become a full participant of the ERM in 1990 and on 15 September 1992 it had to leave the ERM altogether. Italy also left the ERM at the same time. Portugal and Spain devalued in November 1992. The French franc was tested next. In order to avoid speculation against the French


\textsuperscript{94} Branson, n. 92, p.17.
franc, voluminous intra-marginal interventions took place and France had to raise interest rate sharply. By the end of the year the D-Mark had appreciated by 16 percent against the lira, by 13 percent against the pound and by 10 percent against the Spanish peseta. Against all ERM currencies it appreciated by about 6 percent. In its monthly report, the Bundesbank makes no mention of its own role in the ERM crisis. However, it points out that the D-Mark appreciation facilitated price stabilisation efforts by the Bundesbank, and this created the scope for interest rate reductions. “With these reductions it fulfilled a promise made to its partner countries in the negotiations about a realignment.”

After a brief period of normalcy, rising unemployment and public discontent supported expectations of interest rate cuts independent of the Bundesbank’s lead. Interest rate reductions outside Germany reached their limits and by July 1993 the French franc came under severe pressure. In spite of massive interventions to support the franc and the other currencies, the situation worsened. “The increasing volume and intensity of exchange market intervention during July signalled the end of the existing parity grid. A currency realignment was now considered to be out of the question as it would have confirmed the success of one-way speculation”. All attempts to co-ordinate French and German positions failed. The French also suggested that the D-Mark leave the ERM, in order to sustain the system. However, when the Netherlands, Belgium, Denmark and Ireland declared that they would also accompany the D-Mark, France gave up the idea. It was a German-French duel, which ended with the ERM all

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but falling apart. The fluctuation band for ERM currencies was ultimately increased from 2.25 percent to 15 percent.

Apart from these economic effects of German re-unification on the Community, it also unleashed a fear of German resurgence. The re-unification happened fast, without any consultations with the Community partners. It also did not help when the German leaders started making assertive statements. Willy Brandt said, "nowhere is it written that the Germans have to stay stuck in the siding until the all-European train has reached the station." Similarly, the assertiveness showed in the Republican President, Richard von Weizsäcker's words: "We are neither super power nor pawn." Similarly, a committee was set up to meet every week to examine the impact of the German question on the Community. West Germany's senior European Commissioner, Martin Bangemann, chaired it. However, the other Community members felt that a German should not chair such a committee. So, Jacques Delors cancelled the next meeting, but Bangemann persisted till Delors gave in. This was also viewed as German assertiveness and it made the others quite nervous, especially France and so there was an urgency to bind Germany in a European Union. Germany was also keen about making progress on the political union, but France pushed monetary union and Germany agreed to go ahead with it.

The EMU

Debate on the need to reform the existing EMS or to have a new system altogether started in 1988. Jacques Delors and Helmut Kohl worked closely together to prepare

97 Ibid., p. 88.
98 The Economist, "Deutschland, Deutschland iiber alles", The Economist, 13 January 1990, p.49.
99 Ibid., p. 50.
an agreement to move ahead on economic and monetary union at the European Council meeting at Hanover in June 1988. An ad hoc committee under the chairmanship of Delors was set up to study how this union could be achieved. The Delors Report was presented in 1989. It stated that:

Economic and monetary union in Europe would imply complete freedom of movement of persons, goods, services and capital, as well as irrevocably fixed exchange rates between national currencies and, finally, a single currency. This, in turn, would imply a common monetary policy and require a high degree of compatibility of economic and monetary policies and consistency in a number of other policy areas, particularly in the fiscal field. These policies should be geared to price stability, balanced growth, converging standards of living, high employment and external equilibrium. Economic and monetary union would represent the final result of the process of progressive economic integration in Europe.101

The Report said that the first stage would come into effect on 1 July 1990, and would involve central bank governors in presenting finance ministers with recommendations for a closer convergence of macroeconomic policies and performances. The second stage would start at an unspecified date with the entry into force of a new treaty establishing the European System of Central Banks.102 The third stage, also starting at an unspecified date, would lead to “irrevocably fixed” parities and would be sealed by the transfer of most economic and monetary policy powers to the union. National currencies would be replaced by a single currency.

Even though the SEA introduced a chapter on EMU, its content was very thin. In order to have institutional development, it was imperative to have a new inter-


102 The Economist “Germany Weighs In”, The Economist, 24 February 1990, p. 54.
governmental conference (IGC). Accordingly, the European Council meet at Madrid in June 1989 decided, "to carry out preparatory work for the organisation of an IGC to lay down the subsequent stages". Britain was once again alone in opposing the Delors Report. In Roy Jenkins' words, "we came away from Madrid with a commitment for the Treasury to provide an alternative scheme to Delors for monetary union, but with the unspoken desire that it should have as little as possible to do with either union or with a common money".

Accordingly, the UK suggested the creation of a new Community monetary institution, the European Monetary Fund (EMF). The role of the Fund would be managing a "common currency" not a "single currency", which would be called hard ecu. "The UK government is not able to accept the imposition of a single monetary policy and a single currency, and the text does not provide for this." In the Bundesbank's version of EMU, "the establishment of the monetary union signifies the irrevocable fixing of exchange rates between the currencies concerned (with the possibility of their subsequently giving way to a single currency), under conditions of complete, and durably guaranteed, freedom of capital movements. At the same time, this implies the necessity of relinquishing autonomous national domestic and external monetary policies, and of transferring the responsibility for such policies to

102 The bank would have a president and a directorate, nominated for periods of five to seven years, and responsible for exchange rate, monetary and macroeconomic supervision – implying the start of a common monetary policy.


104 Roy Jenkins, "Thatcher: A Satisfactory Alternative to Delors?", European Affairs (Amsterdam), 1/90, Spring, Vol.4, p.54.

Community institutions.” However, the Bundesbank stressed that “divergences which are reflected in particular in the movements of costs and prices, the huge deficits in the national budgets of individual countries, and massive external disequilibria”, especially in the case of the UK, Portugal, Greece, Italy and Spain: need to be controlled and harmonised in order to commence to the final stage.106

For the French government, the objective was EMU and it considered the objective of EMU to be to “ensure sustained non-inflationary growth, a high level of employment and a high degree of convergence in the context of the internal market and of economic and social cohesion.” Further, “monetary union shall entail the irrevocable fixing of parities between the member states’ currencies, leading to the introduction of a single currency, the ecu, and the pursuit of a single monetary policy and the establishment of the European System of Central Banks (ESCB)”.107 While the Belgian government agreed in principle with EMU, it felt that there should be a corresponding effort in the institutional and political fields.108 Belgium never considered the transfer of powers to a supranational authority as a diminution of national sovereignty as in any case Belgium retains little de facto autonomy in relevant areas.109 Similarly, the Dutch government also stressed the need for monetary decisions to be taken by a Community body so as to keep the larger member states

106 “Deutsche Bundesbank’s Statement on Creating Economic and Monetary Union in Europe. 19 September 1990”, in Ibid., pp. 244-47.
from dominating decision-making.\footnote{There was no contention on the question of the need for EMU. It was accepted that EMU was essential to bind Germany in the Union and to maintain stable economic and monetary conditions. However, every member state tried to protect its interests or tried to gain something from the exercise. The British did not feel the need to have a single currency and surrender sovereignty on monetary policy issues. After staying away from the EMS for years, it joined the ERM in 1990 only because it wanted to have a say in the deliberations over EMU. Britain then suggested its own version of EMU to counter the Delors Report. When its suggestions – to have a system of competing currencies or the creation of a parallel common currency, the hard ecu – failed, Britain started thinking of an opt-out. “If it could not set the negotiations on a different track, then Britain would give itself the option of jumping off the train.”\textsuperscript{111} Italy demanded the reform of the system of own resources of the Community in return for its support for EMU.\textsuperscript{112} Similarly, Spain demanded the development of a comprehensive Community concept of re-distributive policy. Spain insisted on interstate cohesion rather than regional cohesion. In return for the convergence criteria put forward at Maastricht, Spain demanded: 1) increase in the share of Community funding allocated to structural programmes in less developed member states; 2) the creation of a new progressive resource, based on the relative wealth of each member state;\textsuperscript{113} 3) the creation of a Fund for member states whose per


12 “Italian Chamber of Deputies, Resolution Adopted on 21 March 1990”, in Corbett, n.103, p. 125.

13 Because Spain had a high propensity of consumption, its contribution to the own resources based on VAT receipts was considerable. Spain feared that within two years it might become a net contributor to the budget. Hence the demand.
capita income was below 90 percent of Community average. The Treaty on European Union finally adopted these demands. The referendum conducted in Denmark and France were further proof of the true sentiments of the people. Finally, with Denmark also being given the option of an opt-out, all ratified the Maastricht Treaty and the Treaty on European Union came into effect on 1 November 1993.

Conclusion

From the Treaty of Rome to the Treaty on European Union the European Community had moved from merely a Common Market to an economic and monetary union. Left to them, the member states hardly felt the need for EMU. External factors forced them to consider a common endeavour. When the dollar ceased to be the world anchor currency, the member states considered linking their currencies to each other. The first such attempt, the “Snake” kept the Community currencies within a band of ± 2.25 percent, and aimed to achieve an economic and monetary union in stages. However, the attempt failed. The Community claims that the “Snake” failed because of the volatile international environment and the oil crisis. But it is also a fact that the “Snake” was attempted to counter the same international situation, and before the effects of the oil crisis could be internalised, the ‘Snake’ had collapsed. In actuality, the member states never wanted to give up sovereignty over their monetary policies. They never wholeheartedly tried to co-ordinate their economic and monetary policies. The “Snake” was necessary because most of the Community members could not have floated their currencies independently. They needed to link their currencies to a stable

currency. When the dollar could no longer do that, the D-Mark was seen as a good enough substitute. Anything more than that was not acceptable.

With the collapse of the “Snake” came the European Monetary System. Every member state had a vested interest in it – if for Germany it meant doing away with the negative impact of a declining dollar on the D-Mark, for the Benelux countries it made sense to link their currencies with the D-Mark. France saw it as a means to import stability into their inflation-ridden economy and as a means to share the leadership role with Germany in the Community. Italy and Ireland also could do with the strict Bundesbank style policies but they ensured sufficient transfer payments before agreeing to EMS. Britain, never happy with surrendering sovereignty and never really believing in the Community, chose to remain out of the ERM.

The EMS years brought stability in the Community. Inflation rates converged and there was price stability. However, harmonisation in crucial areas, for example, fiscal policy, was consciously avoided. In addition, the D-Mark assumed the role of the anchor currency in the system. Germany’s dominance in the system and the Bundesbank’s tendency to dictate strict terms to the other member countries caused consternation. The German re-unification simply made the situation worse. Germany’s traditional rival and neighbour, France, hit the panic button and demanded that Germany prove its loyalty to the Community by proceeding with the EMU. In Britain, there was a lot of hostility towards EMU; its Prime Minister, Mrs. Margaret Thatcher, felt that rushing into a federal system was not the answer. Britain’s Secretary of State for Trade and Industry, Nicholas Ridley claimed the EMU was nothing but a ‘German racket to take over the whole of Europe” and on ceding sovereignty on monetary issues he said, “you might as well give it to Adolf Hitler,
frankly. 115

The Benelux countries, who in the past had always borne the brunt of Germany's might, demanded institutional changes as well as Political Union. "While the inclusion in the Community of a united Germany is already an 'acquis', this does not provide future generations with a sufficient guarantee that a unified Germany will not pursue a course separate from that of the Community. This can only be ensured by so strengthening the Community that the avenue of national 'Alleingang' is closed for good."116 And so, EMU was enshrined in the TEU, to be achieved in three stages. Strict convergence rules were imposed. No member state wanted to be left out; all strived hard to bring their inflation, budget deficits, and price differences under control. In order to determine the transition to the second stage, when there was a suggestion that the Community move towards EMU as and when the member states met the convergence criteria, member states like Italy and Spain felt insulted and strived that much harder to meet the standards.

Since the Maastricht Treaty was signed, member states have moved into stage three. A common single currency, the euro, was created. The euro note is in circulation from 1 January 2002. However, one has to question the political will of the member states to proceed to the stage of full economic and monetary union. In 1999-2000, the euro suffered one of the worst stabilisation crises. The US had to intervene to save the euro. The question is, for a monetary union, is it not essential to transfer sovereignty over economic and monetary policies to the ESCB and at the same time transfer sovereignty from national parliaments to a Community institution (European

115 Dyson and Featherstone, n. 111, p. 568.
Parliament? The member states show no signs of either transferring more power to the European Parliament or to discuss political union. Moreover, now there is a strong possibility of ‘widening’ of the Community. If harmonisation of the policies of twelve (now fifteen) Member States has been a trip to nowhere then one can imagine what it will be like with say twenty or twenty-two members.

In February 2000, a Portuguese banker, Antonio Champalimaud, wanted to sell his banking interests and Spain’s Banco Santander Central Hispano (BSCH) decided to buy them. However, it caused such a furore in Portugal. The idea of a Portuguese bank being sold to the Spanish was anathema to the government and other bankers. The two openly worked to find an alternative to the Spanish bank BSCH buying their bank. Finally, the Portuguese Finance Minister, Antonio de Sousa Franco announced his administrative decision to oppose the deal, citing the advice of the regulatory bodies and that Portugal’s national interests, strategic sectors vital to the economy and financial system should not be interfered with. The European Commission felt that Portugal was flouting rules on the free movement of capital and took the case to the European Court of Justice but finally agreed to Portugal’s compromise as “the take over rules between member states have not been harmonised so its (Commission’s) instrument for deciding whether a deal is acceptable or not is fairly blunt.” This is just a glimpse of things to come.

118 Ibid.