MONETARY INTEGRATION, FROM THEORY TO PRACTICE

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Abstract:
Started in the second half of the 19th century with the creation of the Latin Monetary Union (1865), the European integration has often outrun the economic theories, due to the visionary minds of its initiators that have placed the economic and monetary integration process, from the very beginning, on the track of the success. This is meant to be an overview of the main moments of the integration process, also from the perspective of the theoretical aspects, followed by an in-depth analysis of the structure and functioning mechanism of the present monetary pillar which is the European System of Central Banks. It will also analyse the evolution of the Community priorities, from the beginning till the present challenges put into light by the financial crisis i.e. the reinforcement of the European architecture through the expansion of the fiscal measures beyond the Pact's present requirements and the strengthening of the macroeconomic governance.

Key words: economic integration, monetray integration, European Central Bank, financial crisis, European Union, European System of Central Banks

JET Classifications: E42, E52, E58, F33, G21

1. Introduction

The economic theory has tried to find an answer to the question concerning the best way to accomplish the monetary integration, underlying two main approaches, i.e the economic approach and the monetary one. According to the economic approach, the monetary integration should be preceded by an economic integration in order to avoid any possible imbalances in the real economy caused by investment decreases and slow downs of the economic growth as a result of rising interest rates.

On the other hand, the supporters of the monetary approach argued the primacy of the monetary integration by avoiding the endless process of postponing difficult, but essential economic decisions with a view to monetary integration.

In practice, the history of the monetary integration showed a far more nuanced reality, the sequence of such events as the initial success of the exchange rate mechanism or the process of joining the union of some states with a less developed economy causing the support of one or another of the two approaches or the adoption of a package of measures including measures from both registers.

Thus, at the moment of the first draft of the economic and monetary union, namely the Werner Plan (1971), Europe was divided between the two approaches. On the one hand, the devaluation of the pound sterling (1967), the weakening of the American dollar, the devaluation of the French franc and the revaluation of the German mark represented a series of events that, in their succession, gave a warning signal about the economic divergences between the participating states.

Under these conditions, within the Hague Council of 1967, Germany and Netherlands supported the targeting of the economic convergence with a view to a gradual monetary integration through the fixing of the exchange rates and the creation of a monetary authority. On the other hand, the monetary approach, which focused more on the integration role of the monetary harmonization, was supported by France, Belgium and Italy.

The Werner Plan represented a compromise between those two approaches. Setting the year 1980 as the target moment for the achievement of the economic and monetary union goal, Werner did not submit an clear timetable for the accomplishment of some mid-term objectives, but had as a purpose, in an early stage, to harmonize the economic policy instruments, coordinate the budgetary policies, increase the integration of financial markets and harmonize the monetary and credit policy.

The second phase was to focus on adopting common European directives and transferring the national responsibilities in the economic, commercial, financial and monetary field to Community bodies. It should be noted here that, although the economic theory hadn't offered yet, at that time, all the specific instruments for the monetary integration analysis, the visionary spirit of the Luxembourg Prime Minister understood the importance of the gradualism of the monetary process, given the political register and the characteristics of the European Monetary Union.

Thus, the Union, by its very raison d'être of the Schuman Declaration issued 20 years before, respectively the French-German reconciliation, was, par excellence, the expression of a political will, hence the importance to keep the political autonomy in this early phase. Therefore, the need to fix the exchange rates in order to ensure the perfect substitutability of national currencies, without any lost of the national political controls.

Although it could no longer be implemented due to the effects of oil shocks, the crisis of raw materials and the breakdown of the Bretton Woods system, all these events leading to the strategic redefinition of the European Union, the idea suggested by the Werner Plan referring to the gradual elimination of the fluctuation margins till the irrevocable fixing of the exchange rates, opened the way to the cooperation between the central banks.

The first efforts of coordination made by the central banks materialized within the Monetary Snake set up through the Basle Agreement (1972). The agreement forced the banks to take concerted actions in order to maintain the exchange rate fluctuations within the ±2.25% range, while later on, these efforts intensified within the European Monetary System (1979), with the introduction of ecu.

The Delors Report, which, for the first time, laid down the concrete steps for the achievement of an economic and monetary union, continued on the line of institutional gradualism.

In 1992, The Treaty of Maastricht (amended by The Treaty of Amsterdam – 1997 and the Treaty of Nice -2001) finally established the architecture of the current economic and monetary union, by providing a legal framework to the first pillar of the Union, made up of ECSC, EURATOM and EEC, and by adding other two pillars, i.e. the common foreign and security policy and the home affairs and justice one.

On December 1st, 2009, when the 2007-signed Treaty of Lisbon came into force, the tripolar structure of the European Union was abandoned, the Union becoming thus a single legal entity.

2. The Institutionalizing Phenomenon of the Monetary Pillar

Within half of a century, the concept of monetary integration evolved from the initiatives to establish some forums of national decision-making factors in the monetary area to the creation of the European Monetary Institute and of the current European Central Bank.

The coordination of the monetary policies was organized at first through the creation on the basis of the Treaty of Rome, of the Monetary Committee, made up of representatives of the central banks and of the ministries of finance, as well as of two representatives of the European Commission, after which, the creation of the Committee of Central Banks Governors was decided, in 1964, under the auspices of the ***Bank*** for ***International*** Settlements**.**

Being considered the most important body in terms of money, the Committee represented a forum where participants were presenting their monetary policy intentions in order to discuss technical issues that could ensure a more functional European monetary architecture. Later, through a Council decision in 1990, the Committee's responsibilities were extended with a view to coordinate the monetary policies for the support of price stability.

On a programmatic level, it should be noted that models of institutional integration envisaged for the monetary policy occurred both in the Werner Plan and in the Delors Report, which represents the basis for the creation of the Maastricht Treaty.

Thus, the first document that brought into discussion the idea of a system of European central banks which should develop the monetary policy and the exchange rate policies in relation to third countries was, once again, the Werner Plan, which took as a point of reference the U.S. Federal Reserve System. Unlike the current European project, Werner did not propose the creation of a European central bank, but of a central budget authority.

The same Werner suggested the constitution of the European Monetary Cooperation Fund (EMCF) in order to manage the monetary resources for short and medium term and, possibly, the common foreign currency reserves.

In its turn, the Delors Report submitted the proposals to enlarge the responsibilities of the Committee of Governors, put into practice, as stated above, in 1990, as well as the development of the European System of Central Banks as the monetary core that should preserve the functions of a central bank, namely the development and implementation of the monetary policy, the management of the exchange rates and foreign currency reserves and the guarantee of a smooth operation of payment systems. Delors also put forward the idea of the establishment of an European Reserve Fund, as an embryo of this system.

The proposals of both reports represented the starting point for the current monetary architecture.

Thus, the Luxembourg initiative to establish the European Monetary Cooperation Fund (EMCF) was materialized in 1973, when EMCF was assigned to monitor the EU exchange rates system.

The creation of the European Monetary System (EMS) and the signing of the Agreement between the central banks in Basel (1979) increased the importance of EMCF, whose task became to effectively manage short and medium term funding, the participating states depositing 20 % of their gold and dollars' reserves to EMCF, in exchange for ECU.

Two years after the establishment of EMS, EMCF became The European Monetary Fund (EMF).

Although it was a step forward towards the management of common resources, it should be noted that the establishment of EMCF and then that of the EMS represented only a partial success, given its subordination to ECOFIN. Due to this subordination mechanism, the EMF' works were rather completed through recommendations, whereas the most important decisions were taken in the Committee of Governors. In 1994, the Fund was included into the European Monetary Institute.

As for the proposals of the Delors Report, they were the starting point of the Maastricht Treaty which practically extended the original proposals, by taking the decision of establishing the European Monetary Institute.

The successful reward of all previous efforts made for the purpose of monetary integration was the year 1994, when Europe made the first step towards the creation of a central bank in Europe, by establishing its embryo in Frankfurt, namely the European Monetary Institute (EMI). Led by an Institutional European Monetary Board, EMI aimed at setting up the organizational and functional premises of the European Central Bank.

We will stop for the moment to analyze the gradual approach of the complete integration, i.e. of the introduction of the common currency. Thus, we must notice that the mechanism chosen for this purpose was determined by the specific characteristics of a monetary union of the size of the European one, that have canceled the hypothesis applied at a national level, such as the complete price and wages flexibility among the participating economies. The lack of these hypotheses made impossible the implementation of a shock therapy, without an inflation rates harmonization, as was the case for the monetary integration of the unified Germany. Another alternative would have been the introduction of the common currency in parallel with the national currencies at variable exchange rates determined by the differences between the inflation rates, the national currencies being in the end eliminated from the market by the population that would prefer the less depreciated currency, i.e. the common one. This approach known as the gradualist parallel currency approach has nevertheless its limits, since it starts from the premises that the currencies are perfect substitutes. In reality, as Down and Greenaway have shown in 1994 the currencies are not perfect substitutes, the decision of holding one currency not depending only on the monetary stability it creates, but also on the degree in which other the same currency is used by several people. Down and Greenaway have defined this process as the creation of network effects. Due to the fact that the national currencies create these network effects, the market mechanism wouldn't have allowed the elimination of the national currencies by a common one. The solution adopted by the European Union, presented also in the Werner Plan, was thus the implementation of a mechanism that should ensure the perfect substitution of currencies through the measures took at an institutional level and thus through the establishment of fix exchange rates. The creation of the European Central Bank thus represented the final step of the institutional integration. On the other hand, for the institutional monetary integration to be successful, a *sine qua non* condition is the independence of the monetary pillar. Thus, if, as concerns the European Central Bank, this was ensured during the time of the European Monetary Institute, as concerns the national central banks, this was defined as a precondition of the adhesion to the European System of Central Banks. Thus, as concerns Romania, the independence of the National Bank was declared in its new statute i.e. Law no.312/2004, through its explicit disclaim, the establishment of price stability as an NBR fundamental objective and the ban of direct crediting of the government by the National Bank.

3. The Functioning of the European System of Central Banks

If we analyze the decision-making mechanism of the European System of Central Banks (ESCB) which has at its heart the European Central Bank, founded in 1998, we will note that it has a tricellular structure, dictated by the degree of monetary integration of the participating states.

The centre core is the ECB's Executive Board which coordinates the daily activities of the bank and the operational decision-making for the implementation, at the system level, of the monetary policy settled by the Governing Council. The Executive Board transmits, on a daily basis, operational instructions to the national central banks, being also in charge of the ECB's international reserves management.

Designed to ensure a high degree of responsiveness and adaptability of the monetary institution to the market conditions, the Executive Board is made up of six experts on money and banking issues, including the President and the Vice-President of the ECB. Proposed by the European Commission, after having consulted the European Parliament and the Governing Council, they are appointed to the level of Heads of State and Government by all the Eurozone member states.

The second decision-making plan, with a broader, but central spectrum from a decisional point of view, is represented by the Governing Council, the counterpart, on a higher level, of the Committee of Governors established in 1964. Formed of the Eurozone Governors, the Governing Council is designed to establish the monetary policy stance, which is subsequently applied by the Executive Board. With regard to the decision-making process at this level, the economic reality of the Euro zone has raised the issue of its efficiency. Thus, the accession of Slovakia as the 16th member of the common currency area in 2009 triggered the implementation of the amendments brought on the 1st of May 2004 to the Statute of the ESCB, referring to the freezing to 15 of the number of members eligible to vote. Thus, although all Member States of the Eurosystem take part in the meetings of the Board, the right to vote is granted on a rotary basis, after a pre-determined schedule, so as to ensure permanent representation to vote of the majority of the population in the Euro zone.

The participation mechanism to the Governing Council's meetings reflects the ECB's objectives. Thus, it should be noted here that, in addition to the main objective of ensuring price stability, art.105 of the Treaty on the European Union enrolls the monetary policy on the coordinates of the economic convergence, the ECB taking also the responsibility for the support of the general economic policies of the European Community, without endangering nevertheless the price stability. From this perspective, the President of the ECOFIN and a member of the European Commission (in general, the Economic and Monetary Affairs Commissioner) participate to the meetings of the Governing Council, without a voting right. If the ECOFIN Presidency is held by a non member state of the Eurozone, the place of the ECOFIN President is taken by the President of the Eurogroup[1].

With respect to the monetary objective, this was already quantified under the European Monetary Institute, namely in 1998, as being "an annual growth in the Eurozone of the harmonized index of consumer prices of less than 2%".

In 2003, the ECB Governing Council brought further explanations regarding this issue, stating the pursuit to maintain the inflation rate below 2%. With respect to the time framework of this objective, the ECB decided to ensure the price stability on a medium term.
It should be noted that the defining elements of the ECB's objective were dictated by the realities of a monetary zone with the magnitude of the European one, i.e. inter-regional differences in inflation, the increase of the temporary gap and of the uncertainty degree of monetary policy effects in the event of external shocks.

Thus, the level of 2% was, according to analysts, a sufficient margin to combat inflation on the one hand and, to avoid, on the other hand, the deflationary situations and the costs induced by nominal rigidities. Consequently, the goal became the maintenance of a low inflation rate, yet close to that of 2%, given the fact that in 1999, states in Southern Europe, like Spain and Italy, had

[1] See also "The Functioning of the Eurogroup: Present Problems and Challenges for the Future" - Ivănescu, D., Ivănescu, L., - *The International Conference: Innovation and Competition in European Union*, Bucharest, 2008; ISSN 1841-8678

inflation rates close to 2% (2.2% and 1.7%), while Germany and France registered an inflation rate of only 0.6%.

In general, the policy practiced by the Central Bank proved to be successful, maintaining the inflation rate between 2000 and 2007 at around 2%, except for 2008, when the value recorded was 3.3%. Removing the periodic realignments of exchange rates thus proved the benefits of applying a common monetary policy, whereas between 1970 and 1980 the inflation was 8% to 10%. In 2008, the highest inflation rates were recorded by Spain, Greece and Luxembourg, with values around 4%, while the lowest inflation was attainted by Netherlands, with only 2.2%, according to the data published by Eurostat.

As regards the time horizon, the medium term framework seems to be, with no doubt, the most appropriate solution to achieve both the economic and monetary objectives in the event of external shocks. Thus, a prompt response to the rise of the oil prices for the purpose of targeting price stability on short-term, could lead to high output and employment volatilities, with adverse effects on the long-term price stability.

As concerns the monetary policy strategy, the ECB has adopted a bipolar one, based on the analysis of both the economic risk factors that could determine the price evolution on a short-term, and of the monetary items. With respect to the monetary side, the ECB examines not only the development of M3, but also its counterparts in the consolidated balance sheet of the monetary and financial institutions, as well as the structure of M3 growth, which are essential elements in identifying portfolio shifts, with implications on long-term price evolution. The bipolarity of this analysis underlying the monetary decisions is an item often emphasized by the ECB's representatives. All other strategies, i.e. the exchange rate, inflation or monetary aggregates targeting would have brought about a failure, due to the remarkable size of the European economy, which sums up 329 million inhabitants and therefore has a very low degree of openness, the ignoring of a too wide range of economic factors, less significant at a state level, but most important at a union one, and, respectively, the distortions in the monetary aggregates likely to occur in the adhesion process to a monetary union.

It should be noted that between 1999 and 2003, the ECB closely monitored the development of M3, setting as a target its increase of 4.5% per year. This level had been established as consistent with ensuring price stability. However, the growth attained was 6.5% in 2003, after this point M3 being considered just a simple indicator at the basis of the monetary policy stance.

In terms of the exchange rate policy, as a result of the criticisms received for the decrease in competitiveness due to the significant appreciation of the European currency around the year 2000, the ECB chose the path of a rather stable than strong Euro. Indeed, if between 2000 and 2003, the Euro appreciated from 0.9236 to 1.1312, after this date, for a period of 3 years, the Euro remained at around USD 1.24 per Euro. But the recent years have seen a re-appreciation of the European currency, which culminated with the psychological threshold of 1.5 in November 2009. However, the positive news in the U.S. economy referring to the decrease of the unemployment rate in the United States have brought back the U.S. dollar, the rate falling to 1.42 in December.

The broadest special area covered at a decision-making level within the ESCB, is the General Council that ensures the link between the Eurosystem and the national central banks outside its margins. Made up by the President and Vice-President of the ECB and all the governors of the EU national central banks, the of the General Council's tasks represent in fact a continuation of the EMI's duties as concern the establishment of Euro adoption steps. Among other things, the General Council adopts the convergence reports required by the Treaty and monitors the exchange rate mechanism II by evaluating the sustainability of bilateral exchange rates between the non-Euro area currencies and the Euro.

From this point of view, with respect to the experience of the countries that entered the Euro zone quite recently, we may notice that Slovenia, Cyprus and Malta haven't proved any particular difficulties in maintaining the exchange rate in the immediate proximity of the central parity. A special case was Slovakia, whose exchange course showed significant volatility at the beginning of its participation in ERM II, without getting near the band limit of 15%, and whose economic rigor caused two significant re-evaluations of the national currency against the Euro. As concerns the inflation rate, it generally remained below the reference value, in Cyprus, Malta and Slovakia being around the value of 2.2%. It should be noted here that these achievements were due to the reorientation of the political strategies adopted, Slovenia, for example, abandoning the strategy of targeting monetary aggregates in favour of monitoring the progress in the real and nominal economy. Moreover, Slovakia adopted the inflation targeting strategy and a free floating exchange rate.

If no problems were encountered concerning the long-term interest rates, the fulfillment of the performance criteria was more difficult with respect to the sustainability of the public finances. Therefore, The European Commission initiated the excessive deficit procedure against Malta, Cyprus and Slovakia, which were forced to strengthen their measures of fiscal consolidation.

4. The economic and monetary union: present and perspectives

Concentrating 22.5% of the global GDP, the EU is currently the result of the political will of 500 million people.

Strengthening the common policies can be considered a success, in 2007 the EU reaching 17.4% of the global exports, compared to 11.6% of the U.S., while EU imports were equal to those from the United States, representing 19% of the world imports. Within the Union, the introduction of the single currency has substantially facilitated the trade relations, which have reached one third of the GDP, compared to one quarter, as they were at the beginning of the Union.

Regarding the fiscal policy, the economic and monetary union has managed to recover the gap, due to lower interest rates (from 12% in 1980 to 5% in 2007) and structural and cohesion funds. The criteria of the Stability Pact have determined the decrease of the overall average fiscal deficit in the Euro area from 4% in the 80s and 90s, to 0.6% in 2007.

With respect to the employment, the EU has made great efforts to reduce the unemployment rate, whose results could be seen in the 2005-2008 period, when the unemployment rate was in continuous decline, even though at a higher level than that of the US.

The European Union is nevertheless at a new turning point. Beyond all the efforts made for more than half a century, the current financial crisis has decanted the strong points that Europeans have managed to build, from the new challenges. After increases between 2% and 3 % in the period 2004-2007, the 2008 crisis brought a slowdown in the economic growth to only 0.8%, while in 2009 the GDP declined by 4.1% in EU and by 4 % in the Euro area.

A detailed analysis of the economic situation in the EU highlights growing imbalances within the Euro area and this current situation brings into discussion the rethinking of the fiscal framework. This is due to the fact that the financial interventions meant to support the financial systems led to an alarming growth of the public deficit, which underlines the need for a fiscal coordination beyond the aspects of the deficits and public debts covered by the Stability Pact. In the same time, it becomes more obvious the need for an increased rigor in applying the Pact's provisions during the economic growth, in order to avoid excessive expenditures. The budget deficits have thus become nowadays, together with the differences in competitiveness, the main reasons for concern.

At an economic level, the financial crisis has confirmed the changes of the original hypothesis of the union working mechanism. Thus, if we go back to the origins of the process presented in the beginning of this article, one must notice that one of the particularities of the Werner Plan was exactly the lack of any constrains and sanctions imposed to the participating states and the marginal importance given to the macroeconomic convergence, given that time low divergence coefficient among the participants. These hypothesis are no longer valid in the present context, the enhancement of the macroeconomic coordination for the prevention of excessive imbalances growths and of the asymmetric shocks to which they contribute becoming the main objective for 2010. The monetary union needs now the support of a strong economic governance that should be based on firm commitments from the part of the participating governments. On the other hand, we should notice that the recent obstacles haven't emphasized only negative effects. The success of the European vision was due to the fact that, although faced with an unprecedented global crisis, none of the Member States have adopted protectionist policies as during the Great Depression. The EU States have adopted measures to support the demand that appear to have been successful, given the fact that for 2010 the GDP growth is projected to be at 0.7% in both the Euro area and the EU. The most optimistic forecast in this respect is the one for Poland, of 2.6%, while Germany and France are expected to attain an increase of 1.2%. The only country among the first seven states of the EU and the Euro area where a continuation of the GDP decline is expected is Spain, with 0.6%.

As regards the EU as a world-wide actor, the improvement of the external economic situation may lead to a revival of the exports, but this tendency is still uncertain, depending on the robustness of the global cycle and also on possible late effects of the European currency appreciation during the past periods.

As a conclusion, apart from the inherent negative aspects, one should note the progressive potential of the current crisis. Therefore, if before the crisis, the Member States were quite reluctant to the uniformization of the bank regulation and supervision process, the recent events have impelled the cooperation in this field, by naming the European Committee of Banking Supervision and the European Committee of Systemic Risk in charge of the coordination of the robustness tests performed at a EU level on the Banking institutions and the initiation of the banking supervision and regulatory reform.

In fact, the key solution to the current situation, consisting in the strengthening of the fiscal measures and the implementation of structural measures and of an integrated banking surveillance system, represents after all a new step forward for the improvement of the current economic and monetary union architecture.

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