Revija za evropsko pravo: VI (2004) 1.

Nikola DRAGOJLOVIC

UDK 339.923
str. 43 - 64.
stručni rad

THE EUROPEAN MONETARY UNION

"***We are not bringing together states,***
we are uniting people"
Jean Monnet

Key words: EU, EMU, monetary policy, euro area, ECB, ESCB, Eurosystem, financial institutions

INTRODUCTION

During last sixty years, cooperation between the European countries deepened and European integration became very broad spreading in many different domains. Today, it includes many fields, such as economy, foreign affairs, freedom[21], security, home and justice affairs, and throughout the course of time, several other integration processes were established.[22]

---

[21] Belgium, France, Germany, Luxembourg and the Netherlands signed the Schengen Agreement on 14 June 1985 in a small Luxembourg border town called Schengen. On 19 June 1990, the Convention on the application of the Agreement was signed. The Schengen Convention entered into force in March 1995 in the original five signatory countries, together with Portugal and Spain. Austria, Greece and Italy started to apply the Shengen Convention from the end of 1997. Since March 2001, the Schengen Area comprises 13 EU countries (Austria, Belgium, Denmark, Finland, France, Germany, Greece, Italy, Luxembourg, the Netherlands, Portugal, Spain and Sweden) and two non-EU countries –

The Communities are founded on a theoretical basis of functionalism and neo-functionalism, the ideas of inherent domains and the theory of a spill-over effect. These theories are based on the idea that integration should progress through a few subsequent steps. The first move should be cooperation in fields such as economy, education and culture in which there is a broader consensus (domains that are by themselves oriented on cooperation). After that, a partnership between the countries will continue and facilitate cooperation in the domains with less common interests such as foreign affairs, security and defence.

One of the main aims of the European Union, in order to facilitate and to accomplish higher level of European integration, was to create the European Monetary Union.

The European Monetary Union was established on 1 January 1999 with a single currency (the euro) and a single central bank (the European Central Bank), and on 1 January 2002 euro-denominated banknotes and coins entered circulation. This attempt to create monetary union on European ground was not the only one.[23] The EMU is one of the numerous monetary unions in the world.[24] It is the most major monetary union in the world, and it may become a model for future monetary integration between the other countries.

Iceland and Norway. It is expected that Switzerland could become a part of Schengen Area in 2005.

22 Luxembourg Process 1997 – regarding the enhancement of employment, Cardiff Process 1998 – concerning structural reforms, Cologne Process 1999 – concerning improvement of macroeconomic coordination and Lisbon Process 2000 – regarding better education with the aim of achieving European economy as the most knowledgeable economy in the world in 2010.

23 Throughout European history there were several monetary unions in Europe. In the 1860s existed the Latin monetary union, and at the end of the XIX century – the Scandinavian monetary union.

24 Since 1965, the Eastern Caribbean Currency Union (Antigua and Barbuda, Dominica, Grenada, St. Kitts-Nevis, St. Lucia, St. Vincent and Grenadines, including two British dependencies, Anguilla and Montserrat) has one central bank and a single currency – the Eastern Caribbean dollar. Since 1962-64, the CFA Franc Zone (Benin, Burkina Faso, Cameroon, the Central African Republic, Chad, Comoros, Congo-Brazzaville, Côte d'Ivoire, Equatorial Guinea, Gabon, Guinea-Bissau, Mali, Niger, Senegal, Togo) has two regional currencies (both named CFA franc) and one national currency (Comorian franc) and two regional banks and one national bank (Comoros). The CFA franc is, also used in French Polynesia, New Caledonia, Wallis and the Fortune Islands. CFA franc – the Comptoirs Français du Pacifique franc is a colonial currency linked via a currency board to the euro. Since 1986, the Common Monetary Area (Lesotho, Namibia, South Africa, and Swaziland) has three currencies pegged to the South African rand and four central banks (the South

Significant development of the EMU has to be examined in a wider context of European integration. It has been founded on three milestones:

(a) the economic basis that include common economic interests of the European countries and regions with more than fifty years long history of economic integration through the European Communities,

(b) the political basis made on the strong political will to establish the EMU under the leadership of the Franco-German duo[25], followed by the other EU members, and

(c) the legal fundamentals – treaty basis: Treaty on European Union (as amended) and Protocols to the Treaty.

The Creation of the Euro-Zone was a Crucial Step for European Integration

Bearing in mind that the euro-zone is the second largest economic area in the world[26] after the United States, the creation of the EMU was a significant step in the complex process of European integration. The establishing of the euro area has been the most ambitious project of the European integration. Euroland[27] represents monetary union with a single currency (the euro is a legal tender in all countries of the euro-zone), one central bank (the ECB as an institution with supranational characteristics), and common monetary policy (the ECB is responsible for conducting a monetary policy). Other EU member

African rand is legal tender in Lesotho and Namibia). Cohen, J. Benjamin, ***The Future of Money***, Princeton University Press, 2004, pp.62-66.

25 French president Francois Mitterand and German Chancellor Helmut Kohl

26 The individual economies that are part of the euro-zone may be considered relatively small and open economies, but the euro area as a whole forms a larger and much more closed economy. Measured in terms of population, the euro-zone is the largest developed economy in the world (in 2002 it had a total population of 308 million).

27 12 member states of the EU that have adopted the single currency – the euro: Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal and Spain. Additionally, the euro is used in French overseas administrative areas (French Guyane, Guadeloupe, Martinique, Mayotte, Reunion, and Saint Pierre and Miquelon), Spain's Canarias and Portugal's Açores and Madeira.

countries are not participants[28] in the euro area but some of them are part of the ERM II.[29] Also, some other countries[30] or territories[31] use the euro.

Eeconomic and Monetary Integration

The economic and monetary integration of the European Communities was complex and gradual process, which passed through five phases: a free trade zone[32], a customs union[33] which was completed on 1 July, 1968[34], a common market (the unitary market governing by a single set of rules the commercial relations between member states of the EU), a single market[35] which was created by 1 January, 1993[36], and a monetary union – established on 1 January, 1999 for 11 euro-zone countries (with a single currency – the euro, single monetary policy and a single central bank – the ECB).

Several other processes had a significant impact on European economic integration, such as the European Free Trade Association[37] and the European Economic Area.[38]

---

[28] Non-participating countries (not adopting the euro): Cyprus, Czech Republic, Denmark, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, Slovenia, Sweden and United Kingdom.

[29] Cyprus, Estonia, Latvia, Lithuania, Malta, Slovakia and Slovenia (with fluctuatuion band +/- 15%) and Denmark (with fluctuatuion band +/- 2.25%) are members of the exchange rate mechanism II (ERM II). The Cyprus pound, the Danish krone, the Estonian kroon, the Latvian lats, the Lithuanian litas, the Maltese lira, the Slovakian koruna and the Slovenian tolar are linked to the euro.

[30] Andorra, Monaco, San Marino and Vatican City.

[31] Kosovo and Montenegro – semi-independent; they are still officially integral parts of Serbia and Montenegro.

[32] A free trade zone exists when two or more countries (usually but not necessarily contiguous) consent to remove all restrictions on trade between them, but insist on making individual arrangements for their trade with countries that are not party to the free trade agreement.

[33] Customs union involves free trade between the states and a common set of arrangements concerning trade with other countries.

[34] On 1 July, 1968 customs duties on industrial goods were totally suspended between the member states, 18 months ahead of schedule, and a common external tariff was launched.

[35] The single market, sometimes also known as the "internal market", is the totality of economic activity within the member countries.

[36] The Single European Act (signed in Luxembourg and The Hague, coming into force on 1 July, 1987) paved the way for the creating of the single market by 1993.

[37] The European Free Trade Agreement was established by the Stockholm Convention of 1960. The original signatory countries were Austria, Denmark, Norway, Portugal, Sweden, Switzerland and the United Kingdom. Iceland joined in March 1970 and Finland in 1986. A

THE THREE STAGES OF THE ECONOMIC AND MONETARY UNION

The Economic and Monetary Union was achieved in three evolutionary steps: period before signing of the Maastricht Treaties, period after 1 January 1994 and period in which the EMU started to operate (namely on 1 January 1999).

Pre-EMU Period

The idea of establishing the EMU is not a new one.[39] In June 1989, at the Madrid European Council, Commission President Jacques Delors put forward a plan and timetable for bringing about the Economic and Monetary Union. The Delors Report set out a plan to introduce EMU over three stages.

Stage One of the EMU

Stage One of the EMU started in July 1990 and ended on 31 December, 1993. It was mainly characterised by the dismantling of all internal barriers for the free movement of capital within the European Union. On order to achieve monetary union institutional prerequisites had to be fulfilled. Fulfillment of those preconditions was made possible with signing of the Treaty on European Union (with a Protocol on the Statute of the ESCB and of the ECB and Protocol on the Statute of the EMI).

Stage Two of the EMU, Establishment of the EMI and the ECB

Stage Two of the EMU began on 1 January, 1994. This stage is marked with creation of the EMI, introduction of the Stability and Growth Pact[40] and

---

special Protocol extends the Convention to Liechtenstein, which forms a customs union with Switzerland.

[38] The European Economic Area is a free trade area established by a treaty signed in Oporto on 2 May, 1992 and its members are EU member states and Iceland, Liechtenstein, Norway and Switzerland.

[39] In October 1970 was presented Pierre Werner report proposing a three-stage plan to create an economic and monetary union within a decade.

[40] The Amsterdam European Council in June 1997 agrees on the "Stability and Growth Pact".

launch of the reborn EMS (called also ERM II or new ERM). It also provided the prohibition of financing the public sector by the central banks, the prohibition of privileged access to financial institutions by the public sector and the avoidance of excessive government deficits.

The European Monetary Institute (EMI) was established on 1 January, 1994. The two main tasks of the EMI were:

(a) to strengthen central bank cooperation and monetary policy coordination, and

(b) to make the preparations required for setting up the ESCB, for the conduct of the single monetary policy and for creating a single currency in the following stage.

At Brussels European Council from 1-3 May, 1998, the Union's political leaders made the decision that 11 EU member states fulfilled requirements for membership of the euro area.

The ECB was set up in June 1998 with the aim to introduce and manage the euro by conducting foreign exchange operations and ensuring the smooth operation of payment systems.

Stage Three of the EMU, Irrevocable Fixing of Exchange Rates

Stage Three of EMU began when the euro area started to operate[41] in January 1999 while responsibility for monetary policy was transferred from 11 EU members to the ECB. The ECB has become a supranational institution. The 12th member – Greece joined in January 2001. All these 12 countries fulfilled the convergence criteria set out as economic and legal preconditions for participating in the EMU.

The euro-denominated notes and coins came into circulation on 1 January, 2002. After 28 February, 2002, only the euro is legal tender for the euro area countries.

---

[41] The euro was launched on the money markets on 1 January 1999.

MAASTRICHT CONVERGENCE CRITERIA

Before introducing the euro, all candidate countries were obliged to fulfill a number of convergence criteria, which were aimed to secure the economic and legal preconditions for successful contribution in a stability-oriented monetary union.

Convergence criteria are laid down in the Article 121(1) of the Treaty[42]. These convergence criteria comprise three monetary criteria and two fiscal criteria:

(a) price stability – "the criterion on price stability referred to in the first indent of Article 121(1) of this Treaty shall mean that a Member State has a price performance that is sustainable and an average rate of inflation, observed over a period of one year before the examination, which does not exceed by more than 1½ percentage points that of, at most, three best-performing Member States in terms of price stability. Inflation shall be measured by means of the consumer price index on a comparable basis, taking into account differences in national definitions."[43] (inflation should be less than the unweighted arithmetic average of the rate of inflation in the three countries with the lowest inflation rates multiplied with 1½ percentage points),

(b) long-term interest rate – "the criterion on convergence of interest rates referred to in the fourth indent of Article 121(1) of this Treaty shall mean that, observed over a period of one year before the examination, a Member State has had an average nominal long-term interest rate that does not exceed by more than 2 percentage points that of, at most, the three best-performing Member States in the terms of price stability.

[42] The first indent of Article 121(1) of the Treaty on European Union requires: "the achievement of a high degree of price stability; this will be apparent from a rate of inflation which is close to that of, at most, the three best-performing Member States in terms of price stability".
The second indent of Article 121(1) of the Treaty: "the sustainability of the government financial position; this will be apparent from having achieved a government budgetary position without a deficit that is excessive, as determined in accordance with Article 104 (6)".
The third indent of Article 121(1) of the Treaty: "the observance of the normal fluctuation margin provided for the exchange-rate mechanism of the European Monetary System, for at least two years, without devaluing against currency of any other Member State".
The fourth indent of Article 121(1) of the Treaty: "the durability of convergence achieved by the Member State and its participation in the exchange-rate mechanism of the European Monetary System being reflected in the long-term interest-rate levels".

[43] Article 1 of the Protocol on the convergence criteria referred to in Article 121 of the Treaty.

Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions."[44] (long-term interest rate should be less than the unweighted arithmetic average of the long-term interest rate in the three countries with the lowest inflation rates multiplied with 2 percentage points),

(c) exchange-rate mechanism – "the criterion on participation in the exchange-rate mechanism of the European Monetary System referred to in the third indent of Article 121(1) of this Treaty shall mean that a Member State has respected a normal fluctuation margins provided for the exchange-rate mechanism of the European Monetary System without severe tensions for at least the last two year before the examination. In particular, the Member State shall not have devaluated its currency's bilateral central rate against any other Member State's currency on its own initiative for the same period."[45] (ERM[46] until December 1998; superseded by ERM II as of January 1999)

(d) public deficit – this criterion "shall mean that at the time of the examination the Member State is not subject of a Council decision under Article 104(6) of this Treaty that an excessive deficit exists"[47]; Article 104 sets out the excessive deficit procedure[48], and

(e) public debt – the government debt should not exceed a reference value of 60% of GDP.

---

[44] Article 4 of the Protocol on the convergence criteria referred to in Article 121 of the Treaty

[45] Article 3 of the Protocol on the convergence criteria referred to in Article 121 of the Treaty

[46] On 24 April 1972, the six EEC member countries agreed on system known as the "snake" – the exchange rates between their currencies must not be allowed to fluctuate by more than 2.25%. The European Monetary System (EMS) came into operation on 13 March 1979 replacing the "snake".

[47] Article 2 of the Protocol on the convergence criteria referred to in Article 121 of the Treaty

[48] According to Article 104(2) and (3), the European Commission shall prepare a report if an EU Member State does not fulfil the requirements for fiscal discipline, in particular if:
a) the ratio of the planned or actual government deficit of GDP exceeds a reference value (defined in the Protocol on the excessive procedure as 3% of GDP), unless:
b) either the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively,
c) the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value;
d) the ratio of government debt to GDP exceeds a reference value (defined in the Protocol on the excessive deficit procedure as 60% of GDP), unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

EUROPEAN CENTRAL BANK, EUROSYSTEM AND EUROPEAN SYSTEM OF CENTRAL BANKS

Institutional condition for functioning of the EMU was creation of a monetary institution, which will be responsible for formulating and implementing monetary policy as well as managing external exchange rate policy. The Treaty and the Statute of the European System of Central Banks (ESCB) and the European Central Bank (ECB) formed the ECB and the ESCB. The role of the ECB is to manage the euro and EU monetary policy.

The Eurosystem's decision-making bodies are the Governing Council (18 members), the Executive Board (6 members) and the General Council (27 members). The ECB has the key task to maintain price stability in the euro-zone, preserving the euro's purchasing power.

European Central Bank

The European Central Bank has its seat in the Eurotower in Frankfurt am Main, Germany. The Treaty and the Statute of the ESCB and the ECB has established the ECB and the ESCB on 1 June 1998. The ECB has legal personality under public international law.

The highest decision-making body of the ECB is the Governing Council. It consists of 18 members[49]:

(a) the six members of the Executive Board[50], and

(b) the governors of the national central banks from the 12 euro area countries.[51]

---

[49] Article 10 (1) of the Statute of the ESCB and the ECB: "In accordance with Article 109a(1) of this Treaty, the Governing Council shall comprise the members of the Executive Board of the ECB and the governors of the national central banks."

[50] Jean-Claude Trichet – President of the ECB (since November 2003), Lucas D. Papademos – Vice-President of the ECB, Lorenzo Bini Smaghi – Member of the Executive Board of the ECB, José Manuel González-Páramo – Member of the Executive Board of the ECB, Otmar Issig – Member of the Executive Board of the ECB and Gertrude Tumpel-Gugerell – Member of the Executive Board of the ECB.

[51] Klaus Liebscher – Governor, Oesterreichische Nationalbank, Guy Quaden – Governor, Nationale Bank van België/Banque Nationale de Belgique, Alex. A. Weber – President, Deutsche Bank, Nicholas C. Garganas – Governor, Bank of Greece, Erriki Liikanen – Governor, Suomen Pankki – Finlands Bank, Christian Noyer – Governor, Banque de France, John Hurley – Governor, Central Bank and Financial Services Authority of Ireland, Mario

There are two main responsibilities of the ECB's Governing Council:

(a) to formulate monetary policy for the euro area[52] and set the interest rates at which the commercial banks can obtain money from the central bank, and

(b) to adopt the guidelines and take those decisions necessary to ensure the performance of the tasks entrusted to the Eurosystem.

The ECB's Governing Council meets twice a month in Frankfurt am Main, Germany. Each month, at its first meeting, the ECB's Governing Council assesses and analyses monetary and economic developments and risks to price stability and takes its monthly monetary policy decisions and decides on the appropriate level of the key interest rates, based on ECB strategy. At its second meeting, the ECB Governing Council discusses other issues related to tasks and responsibilities of the ECB and the Eurosystem.

The ECB's Executive Board consists of the President of the ECB, the Vice-President of the ECB and four other members, all chosen be the European Council for a non-renewable term of eight years. It is responsible for implementing monetary policy, preparing of the Governing Council meetings and for the day-to-day management of the ECB.

The ECB's General Council includes the President of the ECB, the Vice-President of the ECB and governors of the national central banks of all EU member countries. It coordinates with the ECB and works on preparation for future enlargement of the euro area. The President of the ECB also attends meeting of the Group of Seven finance ministers.[53]

Draghi – Governor, Banca d'Italia, Yves Mersch – Governor, Banque Centrale du Luxembourg, Nout Wellink – President, De Nederlandsche Bank, Vitor Manuel Ribeiro Constâncio – Governor, Banco de Portugal, Jaime Caruana – Governor, Banco de España.

52 The legal base for the single monetary policy is the Statute of the European System of Central Banks and the European Central Bank and the Treaty establishing the European Community (as amended). The Statute is attached to the Treaty as a protocol. The ECB's Governing Council makes decisions relating to key interest rates, the supply of reserves in the Eurosystem, monetary objectives, and the establishment of guidelines for the implementation of those decisions.

53 The Group of Seven (G-7) Summits are regular meetings held since 1975 of the heads of government and finance ministers of the seven leading industrialised countries (Canada /since 1976/, France, Germany, Italy, Japan, the United Kingdom and the United States). These summits have also been attended by the President of the European Commission (since May 1977) and latterly also by the President of the Russian Federation (hence the name G-8 or G-7 plus one).

Eurosystem

The Eurosystem comprises only of the ECB and the national central banks of those countries that are participants in the euro-zone. The ESCB and the Eurosystem will co-exist as long as there are EU member states outside the euro-zone.

The Eurosystem combines two principles in its organisational structure:

The principle of unity – in decision-making process (all governors of the national central banks of euro-zone member states sit and decide together in the ECB Governing Council), and

The principle of decentralisation – in structure and in implementation of the decisions (national central banks implement the decisions of the Eurosystem).

Some observers argue that the Eurosystem is too decentralised.[54] The governors of the national central banks have a clear majority (12 out of 18 members) in the ECB Governing Council.[55]

European System of Central Banks

The ESCB is a system of national central banks introduced by 1 July 1998. Some other systems of central banks last for quite a long time.[56]

The ESCB consists of the ECB and the national central banks of all EU members states (whether they have adopted the euro or not).[57] The Governors of national central banks of those EU member countries that have not yet accepted the euro do not contribute to the monetary policy decision-

---

[54] Begg, D., De Grauwe, P., Giavazzi, F., Uhlig, H., and Wyplosz, C., "The ECB: Safe at Any Speed", ***Monitoring the European Central Bank 1***, London: Centre for Economic Policy Research, 1998.

[55] The US Federal Reserve System's decision-making body is the Federal Open Market Committee that comprises 12 members (5 of 12 members are presidents of regional banks; the other seven members (the Board of Governors) are appointed by the Congress).

[56] The FED is established in 1913. The main bodies are the Federal Open Market Committee (12 members) and the Board of Governors. A mandate of the Chairman of the Board of Governor lasts 14 years. The Chairman of the Board of Governors is Alan Greenspen (since 1987). For US monetary policy is responsible the Federal Open Market Committee.

[57] Article 107 (1) of the Treaty establishing the European Community.

making for the euro-zone and such national central banks do not participate in the operational implementation of these decisions.

THE MONETARY POLICY OF THE ECB

The monetary policy of the ECB is based on the theories of moderate monetarists. The ECB completely adheres to the fundamentals – a fixed exchange rate, monetary discipline and neutrality of money.

The general principle "long-run neutrality of money" is a part of the contemporary macroeconomic perspective. In the long term, real economic growth and employment are determined by real factors, such as population growth, technology or the economic preferences. The process known as the monetary policy transmission mechanism is very complex. A change in short-term interest rates induced by the ECB, influences developments in economic variables such as output or prices. As Friedman argued, the economy streams towards a "natural rate of unemployment" which in the long run is mostly independent of the rate of inflation and cannot be changed by monetary policy.[58] After all adjustments in the economy, a change in the quantity of money will reflect in a change of general level of prices but it will not bring permanent changes in real variables such as employment and real output. Economic growth cannot be enhanced by increasing the money supply or by keeping short-term interest rates at a level inconsistent with price stability.

Objectives of Monetary Policy

The primary objective of the Eurosystem is to maintain price stability[59] and monetary policy for which it is responsible. Maintaining price stability is the best contribution monetary policy can make to a favourable economic environment and job creation.

---

[58] Friedman, M., "The Role of Monetary Policy", ***American Economic Review*** 58, 1968, pp.1-17

[59] Article 105(1) of the Treaty: "The primary objective of the ESCB shall be to maintain price stability." And: "Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community as laid down in Article 2."

According to the Article 2 of the Treaty on European Union, the objectives of the Community, inter alia, are "a high level of employment and social protection" and "sustainable and non-inflationary growth, and high degree of competitiveness and convergence of economic performance".

The Eurosystem will support general economic policies and objectives of the Community, which include a high level of employment and sustainable non-inflationary growth.

The Treaty sets up a clear hierarchy of objectives for the Eurosystem and assigns overriding importance to price stability. Provisions of the Treaty reflect the broad consensus that:

(a) the benefits of price stability are substantial – a crucial pre-condition for increasing economic welfare and growth is maintaining price stability on a sustainable basis, and

(b) the inherent role of monetary policy is to maintain price stability.[60]

In line with this view, the ECB will provide price stability with the intention to facilitate competitiveness and efficiency at the market. This will make a good environment for a sustainable path of economic growth, stimulate a high employment rate and create stable investments.

Other objectives of the ECB, than price stability, are very vague in the Treaty. The ECB has interpreted that it has to pursue only price stability (and it is only responsible for price stability) and therefore it is not responsible for the employment and business cycle developments.[61]

Tasks of the ECB

The tasks of the ECB can be divided into two large groups:

(a) basic tasks:

1) the definition and implementation of monetary policy for the euro area,
2) the conduct of foreign exchange operations,
3) the holding of the management of official foreign reserves of the euro area countries (portfolio management), and
4) the promotion of a smooth operation of payment systems

[60] The monetary policy can be used to make a favourable effect on real activity but only in the shorter term. The ECB should take into account broader economic goals and avoid generating fluctuations in employment and output if this is in line with the pursuit of its primary objective – price stability.

[61] De Grauwe, Paul, "Living with the Euro. A Provisional Balance Sheet", European University Institute, Florence, 2003, pp.5-6

(b) additional tasks:

1) the ECB has the exclusive right to authorize the issuance of banknotes in the euro-zone,
2) the ECB collects statistical information necessary for fulfilling the tasks,
3) the Eurosystem contributes to a smooth conduct of policies pursued by the authorities in charge related to the prudential supervision of credit institutions and the stability of the financial system, and
4) the ECB maintains working relations with relevant institutions and bodies both within the EU and internationally in respect to tasks entrusted to the Eurosystem.

The ECB Monetary Policy Strategy and Its Role

The ECB has adopted strategy to ensure the successful implementation of its monetary policy.

The ECB monetary policy comprises two main elements:

- a quantitative definition of price stability, and
- a two-pillar approach to the analysis of the risks to price stability.

The quantitative definition of price stability envisages through the ECB definition of price stability as a year-on-year increase in the Harmonized Index of Consumer Prices (HICP) for the euro-zone of below 2%. In order to achieve that goal, the ECB endeavours to maintain inflation rates below, but close to, 2% over the medium term.[62] Grauwe argues that the ECB ought to redefine its target of inflation rate to be between 2% and 3%, which is the optimal rate for economic growth in accordance with contemporary theory.[63]

The ECB strategy includes an analytical framework based on two-pillar approach:

---

[62] The ECB's Governing Council made very clear its objective "to maintain inflation below 2%, but at the same close to this percentage". European Central Bank (2003), ***Monthly Bulletin***, June, p. 81.

[63] De Grauwe, Paul, ***op. cit.,*** p.17.

- the monetary pillar – the growth rate of money M3[64] reference value of 4,5% should not be exceeded, and
- the economic pillar – a wide range of indicators of future price developments (inter alia: wages, the exchange rate, bond prices, price and cost indices and business and customer surveys…[65]).

The ECB does not change level of interest rates in altered economic milieu – when it leads into expansion or recession of economy. Thus, it can be concluded that the growth rate of output and business cycle developments have a very small effect on ECB decisions when deciding its monetary policy.[66]

The operational framework for implementing a single monetary policy comprises of a set of monetary policy instruments and procedures. It is based on the principles laid down in Article 105 of the Treaty on European Union and it states that in pursuing its objectives, the Eurosystem "(…) shall act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources (…)". In addition to these principles, the operational framework follows several guiding principles:

- operational efficiency – a capacity of the operational framework to enable decision to feed through as precisely and as fast as possible to short-term interest rates,
- equal treatment and harmonization – equal treatment envisages the fact that credit institutions must be treated equally despite their size and location in the euro area; harmonization of rules and procedures helps to ensure equal treatment,
- decentralized implementation – the ECB coordinates the operations and national central banks carry out the transactions, and
- simplicity, transparency, continuity, safety and cost efficiency – simplicity and transparency should secure that the intentions behind monetary policy operations are correctly understood; continuity aims to avoid major changes in instruments and procedures, so that central banks and their counterparties can relay on previous experience; safety calls for that

---

[64] Money supply "M3" – banknotes and coins, short-term deposits and short-term marketable instruments.

[65] European Central Bank (1999), ***Monthly Bulletin***, January, p. 49.

[66] De Grauwe, Paul, ***op. cit***., p. 7.

the Eurosystem's financial and operational risks are kept to a minimum; cost efficiency intends to keep the operational costs low.

Those two analytical perspectives – monetary and economic analysis and its cross-checking form is the basis for the ECB Governing Council's general valuation of the risks to price stability and its monetary policy decisions.

The ECB gives a prominent role to money in the formulation of its monetary policy strategy. It is influenced by the monetarist, inter alia, by Milton Friedman and analysis that inflation is always a monetary phenomenon.

On the other side, De Grauwe gives a subsample of states, which had an average rate of 5% or less during 1970-1999 period and claims that "there is very little relation between inflation and money growth in these "low" inflation countries".[67]

The ECB is the Monopoly Supplier of Monetary Base

The ECB is the sole issuer of banknotes and bank reserves in the euro area and the monopoly supplier of the monetary base, which comprise:

- currency (banknotes and coins) in circulation,
- the reserves held by counterparties with the Eurosystem, and
- recourse by credit institutions to the Eurosystem's deposit facility.

Counterparties are obliged to hold reserves with the national central banks in the Eurosystem's minimum reserve system.

The ECB is the sole issuer of banknotes and bank reserves. It is authorized to set conditions at which banks borrow from the ECB, and influence the conditions at which banks trade with each other in the money market.

As a central bank, the ECB is able to run the liquidity condition in the money market and shape money market interest rates. With the purpose of keeping inflation under strict control, the ECB regulates money supply. Many contemporary economic analysts agree that if the money supply is excessive compared to the supply of goods and services, it will result in inflation. Setting interest rates throughout the euro-zone is one amongst the many tools used by the ECB for controlling the money supply.

---

[67] De Grauwe, Paul, ***op. cit.***, p. 19.

Implementation of Monetary Policy

The ECB conducts its monetary policy by steering short-term interest rates. With shaping short-term interest rates, the ECB affects economic developments and growth with the purpose of maintaining price stability in the euro-zone over the medium term.

In the aim of implementing its monetary policy decisions, the ECB Governing Council has adopted a set of monetary policy instruments and procedures as determined in the General documentation on Eurosystem monetary policy instruments and procedures.

The framework is considered necessary for the comprehensive evaluation of all relevant information and analysis needed to make monetary decisions.

The ECB Has Larger Independence than Any Other Central Bank

The ECB is fully protected from political interference.

The independence of the ECB is larger than the autonomy of any other central bank in the world[68], and directly given and ensured by the Treaty. The ECB is completely independent. Moreover, neither the ECB, the national central banks of the Eurosystem, nor any member of their decision-making bodies can ask for or accept instructions or advice from any other body, institution or official.

The ECB has large independence composed of:

(a) institutional independence – the ECB has been vested with a legal personality by the Treaty and it is an institution independent from any other,

(b) instrument independence – the ECB can choose instruments that would be used to accomplish its objectives, and

(c) goal independence – the ECB has power to determine and define its own objectives without influence from any other EU institution.

---

[68] Eijffinger, S., and de Haan, J., "***European Monetary and Fiscal Policy***", Oxford: Oxford University Press, 1999.

The ECB is obliged to inform the European Parliament about its policy, but this does not constitute a formal accountability.[69]

Transparency and Accountability of the ECB

The ECB is not accountable to any institution and has full independence.

The minutes and actual voting records of the ECB Governing Council meetings are not provided. The monetary policy decisions are announced at the press conferences chaired by the President and assisted by Vice-President of the ECB Governing Council held shortly after the first meeting each month. Publicity is provided in ECB Monthly Bulletins and Annual Reports.

Also, the strategy gives a framework for clarifying monetary policy decisions to the public in an unambiguous and transparent way. A high degree of transparency helps the central bank to confirm its accountability to the public.

The established confidence in the euro and credibility of the ECB and its anti-inflation policy is based on the credibility theory of inflation.

The ECB lacks in transparency and accountability, as it does not provide to the public its minutes, nor voting records.[70]

Eijfinner proposes several types of transparencies for measuring bank transparency: political, economical, procedural, policy and operational transparency.[71]

In addition, the ECB lacks accountability because a mechanism to check whether the ECB fulfils its mandate does not exist and there are no sanctions for that kind of action. The ECB has no political accountability, which is a widely recognized democratic principle. Simply, a system of political accountability (first stage: power is delegated and independence is granted; second stage: control is exerted (accountability) by the political body that granted power; third stage; voters at general elections approve or not the previous acts – give a new mandate or not) does not apply to the ECB.

---

[69] The President of the ECB gives a statement before the European Parliament, but Parliament has no power at all to change the Statute of the ECB. Only the Treaty, requiring unanimity of all 25 EU member countries can change the Statute.

[70] The minutes of the Bank of England are available to the public.

[71] Sylvester C.W. Eniffinger & Geraats, M. Petra, "How Transparent Are Central Banks", 2003, p. 3-4.

THE EURO-ZONE AND US DOLLAR

The U.S. dollar has been the dominant world currency for the past 60 years. Furthermore, the dollar is used as a currency is some countries[72] outside of the United States. An international currency, such as the dollar, has three roles:

- a medium of exchange,
- a unit of account, and
- a store of value.

The idea of the euro challenging the dollar's role as the world's currency is valid from the store of value perspective – capital preservation and risk diversification through portfolio diversification away from dollar assets.

The euro has hegemony in the euro time-zone. One author[73] proposes several reasons why the dollar is stronger than the euro:

- inertia of monetary behaviour,
- cost of doing business in euros,
- an anti-growth bias within the EMU, and
- the ambiguous governance structure of the EMU.

Also, one more argument can be added to that list:

- the financial center of the euro is outside of the euro-zone.

The monetary center of the euro is located in Frankfurt am Main, Germany, in the euro-zone, which is not the case with London as the euro's financial center. The other two key world currencies, both the dollar and yen, have its monetary and financial centers in their own zones in New York and Tokyo. Compared with them, the euro has a disadvantage and getting London, if

[72] The dollar is a currency in East Timor (since 2000), Marshall Islands (since 1944), Micronesia (since 1944) and Palau (since 1944). Panama (since 1904), Ecuador (since 2000) and El Salvador (since 2001) rely primarily on dollar but also issue a token local currency. Some bimonetary countries such as Bahamas, Haiti and Liberia have the dollar in circulation that is legally recognised but is subsidiary to the local currency as legal tender. Also, the dollar is currency in American Samoa, Guam, Johnston Island, British Virgin Islands, Bermuda (alongside with Bermuda dollar) and Cayman Islands (alongside with the Cayman dollar).

[73] Cohen J. Benjamin, "Global Currency Rivalry: Can the Euro Ever Challenge the Dollar", *Journal of Common Market Studies*. Volume 42, Number 4, 2003, p. 575-595.

there is such a perspective, into the euro-zone will cure the euro and perhaps even make the euro currency number one in the world.

The ECB has a very hard job to do. The euro area shows at least not so little regional variation in business cycles and the ECB one-size-fits-all monetary policy leaves some regions in recession while others experience rapid growth. The US is also not an optimal currency zone but it has federal programs that act as automatic stabilizers transferring tax revenues from growing regions to bad performing areas as unemployment insurance or health benefits for the poor. US's labour market is also much more flexible than the one in the euro-zone.[74] This view is supported by the theory of optimum currency area that is based on a large common budget and labour mobility. Euro-zone lacks both of them (EU budget is around 1% of GDP and EU workers stay in their own country and very rarely migrate to some other state, no matter how bad the economy). The gap in living standards between the US and Europe could also be explained by differences in the level of competition in product and labour markets.

As it was expected the ECB left its main interest rate unchanged at 2% until the end of 2005 but interest rate was slightly increased in two steps in November 2005 (reached 2.25%) and in March 2006 (reached 2.5%).[75]

Figure 1: Interest rates of the ECB and FED for the period Jan 2002 – Mar 2006

[74] "Can This Union be Saved?", ***The Economist***, Jun 6th 2005, The Economist Global Agenda, http://www.economist.com.

[75] It was more than two years without change. The OECD recommended that the ECB should cut rates by 0.5% to "address this chronic pattern of weak resilience and diverging activity within Euroland as thoroughly and promptly as possible". Mr Erkki Liikanen, governor of the Bank of Finland, indicated that the ECB expects that its next interest rate move be upwards: "There is a monetary stimulus in the market place. At some point in the future, policy should move towards a more neutral position".

Atkins, Ralph and Schieritz, Mark (2005) Eurozone's weakness baffling, says banker, ***Financial Times***, 25 May 2005, p. 8

NEW CANDIDATES FOR EMU MEMBERSHIP

One of the potential candidates for EMU membership is Slovenia. In line with the actual economic development of Slovenia, it may start to use the euro as a currency in January 2007. Also, Cyprus and Malta are candidates for EMU membership (both of them should push down their public deficit for about 2% and public debt for about 15%).

Table 1: Performance of the Maastricht criteria by new EU member states

New EU member state	Inflation	Interest Rate	ERM II	Public Deficit	Public Debt	Percentage of GDP per capita average in EU
Cyprus	2,1%	5,2%	*	5,2%	72,6%	83,0%
Czech Republic	1,8%	4,7%		5,0%	37,9%	69,0%
Estonia	2,0%		*	+ 0,3%	4,8%	49,0%
Hungary	6,5%	8,1%		5,5%	59,9%	61,0%
Latvia	4,9%	5,0%	*	2,0%	14,7%	41,0%
Lithuania	-0,2%	4,7%	*	2,6%	21,4%	46,0%
Malta	2,6%	4,7%	*	5,2%	73,8%	75,0%
Poland	2,5%	6,9%		5,6%	47,2%	46,0%
Slovakia	8,4%	5,1%	*	3,9%	44,5%	52,0%
Slovenia	4,1%	5,2%	*	2,3%	30,8%	77,0%

CONCLUSION

There is no doubt that the ECB monetary policy is quite successful and inflation in the euro-zone has been kept at a low level.

The euro had more success (maintaining of low level of inflation) than failure (unemployment) and from time to time sufficient accomplishments (the establishing of one of the major world's currencies and coordination with the fiscal policy).

Nikola DRAGOJLOVIĆ

EVROPSKA MONETARNA UNIJA

Resume

European integration that includes common economic and monetary policy came through long-lasting evolutionary process. Passing though different steps - free trade zone, customs union, common market, single market, monetary union with a single monetary policy and a single currency, it moves into one broad economic union that will deepen the cooperation between the European countries. Foundation of the European monetary union (EMU) required creation of the institution and mechanisms for managing and applying a single monetary policy at the euro area as far as running the euro exchange rate policy. The EMU was achieved in three steps: stage one, that has goals to complete freedom of capital movement and increased co-operation between central banks; stage two, during which the European monetary institute (EMI) was established, and introduced ban on the granting central bank credit to the public sector, process leading to independence of national central banks; and stage three, that formally started on 1 January 1999 when the European central bank (ECB) started to operate, marked with beginning of use of a single currency – euro in a daily life (euro denominated banknotes and coins are put into circulation on 1 January 2002). Moment when euro banknotes and coins entered in circulation is a great landmark in the European history. Euro is not only legal tender, but much more. It is a cohesion factor that contributes to creation of feeling that all nations are belonging to the European family and European civilisation.