LEGAL FRAMEWORK OF THE EUROPEAN MONETARY SYSTEM AND THE EUROPEAN MONETARY UNION

Tamara Capeta, M.A.

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Address:

Institute for Development
and International Relations
Ul. Lj. F. Vukotinovi}a 2
41000 Zagreb
Croatia
E-mail: tamara@mairmo.irmo.hr
tel: /385/1/4554-522
fax: /385/1/444-059

INTRODUCTION

By signing the Treaty on European Union in Maastricht in February 1992, the Member States of the European Communities decided to start the new phase in the integration process which was initiated in 1950. The most important feature of the Union Treaty which is of interest for this paper are the provisions which envisage the creation of a monetary union.

The most quoted economic argument in favour of the monetary union is a Padoa-Schioppa's "inconsistent quartet". Out of the four elements of this quartet: free trade, full capital mobility, exchange rate fixity and national monetary sovereignty, at least one is inconsistent with the others. After 1993 when the single market was established in the European Community, the three elements of the quartet were fulfilled. The single market meant the free circulation of goods, services, people and capital, and the exchange rate fixity was established through the exchange rate mechanism of the EMS. In such a situation, the element which should give way is national sovereignty in monetary policies. Therefore, the monetary union, which according to the Delors Report1 requires the adoption of a common monetary policy the responsibility for which would have to be vested in a new, common institution, is the logical and necessary consequence of the single market. Once it is created, the states will lose their competences over monetary policy and centralize it at the Community level.

But, if monetary union can economically be regarded as a logical consequence of the single market, it is not also a legal consequence.2 The only way in which the part of national sovereignty can be shifted to the common institution is through the Treaty on which the European Community is based. Therefore, in order to give to monetary union a proper legal basis in the Community framework it was necessary to change the Treaties. This is why the Maastricht Treaty was a necessary step on the way to creation of monetary union.

Thus, the Maastricht Treaty created legal precondition for establishing a monetary union. However, before the monetary union is realized, a certain time has to elapse, during which the competences over monetary policy will stay in national hands. Consequently in this transitional period, the monetary situation will be very unstable, because the three other elements of the quartet have already been fulfilled. According to David Cobham, in a given situation, "the uncoordinated national monetary policies will create balance of payments disequilibria, and threaten the fixity of exchange rates."3 Therefore, in order to maintain the stable monetary situation during the transitional period, the coordination of national monetary policies has to be strong.

This paper will try to show that the Maastricht Treaty, which represents the legal framework for the realization of monetary union, has not offered the appropriate solutions for the transitional period. The institutional framework within which the monetary cooperation was organized prior to the Maastricht Treaty is the European Monetary System (EMS), and the new Treaty has not changed anything in either legal or institutional organization of the EMS, which was created in 1979. The success of the monetary union will, therefore, greatly depend on the functioning of the "old" EMS which, in the changed circumstances, especially due to the liberalization of capital movements, may prove to be unable to maintain monetary stability. The recent currency crisis, which lasted from September 1992 until August 1993, was a
first proof of the EMS vulnerability.

THE EUROPEAN MONETARY SYSTEM - LEGALLY OR POLITICALLY BINDING ARRANGEMENT?

The European monetary system was created in 1978 by the Resolution of the European Council4 and came into operation in March 1979. It came as the reaction to the disorder which existed in international monetary relations since 1971, after the collapse of the Bretton Woods par-value system.5 Its primary goal was to bring back the order to Community monetary relations and to create a zone of monetary stability in Europe which would enable the growth of intra-Community trade and help in maintaining the Common Agricultural Policy and in realizing the single market. The Resolution on EMS was originally drawn up to govern only the initial phase of the EMS, while the whole system was to be revised no later than two years after the start of the scheme. The idea was to consolidate the system by creating the European Monetary Fund and by enabling full utilization of the ECU as a reserve asset and a means of settlement. The new system should have been based on adequate legislation on the Community and national levels.6 This, however, was not done. So far the system has been working as it did when it was set up, with two packages of measures designed to strengthen it, introduced in 1985 and 1987.7

The relatively stable economic and monetary situation in Europe, which could partially be attributed to the EMS (but, it is not possible to measure how much the EMS contributed to the achievement of stability, or to say that without the EMS the situation would have been worse) created the environment in which it was possible to come, for the second time in the history of the European Community, to a decision to create an economic and monetary union.8 The EMS is
regarded today as a step on the way to the monetary union. But, the fact that the EMS can be used as an instrument to build the economic and monetary environment which would make the move towards a real monetary union possible, does not mean that the objective of monetary union can be attached to the EMS itself. As was stated by David Cobham: "the objective of the EMS was not to pave the way for monetary union, but simply to create a zone of monetary stability, in which exchange rates were relatively stable and inflation was relatively low."9 The decision to establish a monetary union was a political decision and it represented a qualitative step further in relation to the previous situation.

From the legal point of view, the EMS is more a politically binding than legally binding arrangement. Why is it so? The EMS was never, as it was envisaged when it was created, brought under the

competence of the Community law, but was operating outside the legal and institutional framework of the European Communities. The EMS is based on a variety of legal instruments, which are not all of Community origin, and whose legal nature and consequently the kind of sanctions that follow for not complying with its rules, was of a great interest for lawyers. This has not changed after the last amendments made under the Maastricht Treaty.

Four main legal sources govern the functioning of the EMS:

- the Resolution of the European Council on the establishment of the EMS and related matters, of 5 December 1978 (hereafter "the Resolution");

- several Regulations and Decisions of the Council;10

- Agreements between Central Banks of the Member States ;11

- Decisions taken by the Board of Governors of the European Monetary Cooperation Fund (hereafter EMCF).12

The most important features of the exchange rate mechanism (ERM) of the EMS (provisions on maintenance of stable exchange rates and intervention mechanism) are regulated only in the European Council Resolution and were
never transposed to proper Community legislation. At the same time, by joining the ERM the Member States accepted great limitations of their freedom to act in monetary field, in so far as it is provided in Article 3.2 of the Resolution that the "adjustment of central rates will be the subject to mutual agreement by a common procedure which will comprise all countries participating in the exchange rate mechanism and the Commission." Having this in mind, it is necessary to analyze the nature of the obligations undertaken by joining the ERM.

There are two legal problems related to the European Council Resolution. The first one lies in the body which initiated the EMS - namely, the European Council. It is not an institution of the Community and it was not even legally recognized until 1979, when the Single European Act entered into force.13 This formal recognition still did not mean that the European Council was included in the decision-making institutional framework of the EC.14 A resolution, on the other hand, is the kind of act which is not defined anywhere in the Treaties. Therefore, as much as a Community law is concerned, the EMS is based on the "non-act of a non-body". The rules on the maintenance of the exchange rate stability are not therefore the rules of the Community law.

The Single European Act, which introduced the new chapter into the Treaties entitled "Cooperation in Economic and Monetary Policy (Economic and Monetary Union)" in which the EMS is expressly mentioned, did not bring the EMS under the authority of the Community law. Jean Victor Louis has stated that "the Single European Act does not embody the whole EMS within the Community legal order. It remains as it is: a mixture of resolutions of the European Council, regulations of the Council of Ministers, agreements between Central Banks and decisions of the Board of directors of the FECOM." It "does not mean that a new legal basis has been given to the EMS. Rather, the reference to the "respect of existing powers in this field" tends to preserve the plurality of legal sources for the future."15 The situation is the same even after the Maastricht Treaty came into force. Namely, its article 109m uses almost the same wording as the old article 102a of the SEA, envisaging that during the transitional period member states "shall take account of the experience acquired in cooperation within the framework of the European Monetary System (EMS) and in the developing the ECU, and shall respect existing powers in this field."

What is, then, the legal nature of the Resolution and has it created any legal obligations for the Community member states? The majority of legal writers do agree that the Resolution is a source of international law.16 Being and staying an international arrangement outside the scope of the Community law, the EMS provisions cannot be enforced through the Community enforcement procedures. Neither Community institutions nor other member state can legally force a member state to act in accordance with the EMS provisions, and prevent it to, for example, unilaterally devalue its currency.

Therefore, the motivation for the compliance with the rules of the EMS does not come from the member states' awareness of the legal consequences that could follow in case of the breach of the provisions. It could rather be found in the will of the member states to maintain the system in the operation for economic or political reasons. Thus, the success of the EMS as an instrument for securing the monetary stability in the European Union will depend, during the transitional phase towards the monetary union, solely on the political will and determination of States to use it as such an instrument. It could not be regarded as a legally binding instrument which could by the force of law make member states to act in accordance with its rules. However, given the new goal of the integration process in Europe, and with the perception of the EMS as an instrument to accomplish it, it could be expected that the member states will continue to fulfil the obligations of the EMS, under the condition that the political will to create a monetary union continues to exist.

THE INHERENT SHORTCOMINGS OF THE EMS INSTITUTIONAL STRUCTURE IN THE TRANSITION TO MONETARY UNION

The second important element for the success of maintaining the stable situation in the transitional period, is the market perception of the appropriateness of the EMS as an instrument for maintaining the exchange-rates and price stability, and the credibility of the Member States determination to create a monetary union. If the EMS is perceived as a very fragile framework for maintaining the exchange rates, the market will take the opportunity to make a profit out of its shortcomings. The currency crisis of 1992/1993 has shown that the EMS mechanisms are really vulnerable.

The most important inherent shortcoming of the institutional structure of the EMS lies, according to Robert Verkampf,17 in the asymmetrical organization of its mechanism for financing interventions.

When one looks at the intervention rules of the ERM, the mechanism seems, at first sight, perfectly symmetrical. The obligation for intervention is based on the bilateral relations between the two currencies, which means that they
simultaneously reach their upper or lower intervention points. The obligation to intervene arises for both currencies. How is the intervention done? The intervention is pursued in a hard currency. The Central Bank of the hard currency sells its currency and buys a week currency, and the Central Bank of the weak currency buys its own currency paying it with the hard currency, influencing in that way the offer and demand for those currencies. At the moment when the reserves in the hard currency of the Central Bank of the weak currency are exhausted, the financing mechanism, the so called very-short term facility opens. Central banks participating in the intervention are obliged to open a credit of unlimited amount in their currency. This means that the unlimited amount of the hard currency becomes available for the weak currency central bank for the purposes of the intervention. The credit under short term facility is denominated in ECU, and the financing operations take the form of spot sales and purchases of Community currencies against the crediting or debiting of accounts denominated in ECU and held by the European Monetary Cooperation Fund (EMCF).18 But, after the intervention, the repayment obligation arises. The intervention credit falls due after three and a half months,19 which means that after the relatively short period the budgetary restriction of the weak currency country is reestablished. Due to the so called settlement rules of the EMS, it is always the central bank of weak currency that finances the entire intervention. Namely, the interventions of the hard currency central bank at its upper intervention point in which it acquires a weak currency assets, are transferred to the EMCF, where they represent ECU-assets for the hard currency central bank and

the ECU-liabilities for the weak currency central bank. Therefore, interventions of hard currency central banks are at the end treated like credit-financed interventions of the central bank of the weak currency.20

Such a system, in which a complete burden of the intervention falls on the weak currency, and in which the promise of successful maintaining of a given exchange rate of a weak currency is limited to only three and a half months, is not credible to the market.

Additional to that, there is another weak point of the EMS. If by the intervention the exchange rate of a currency cannot successfully be maintained, the currency is to be devalued (or a hard currency revalued). In an exchange rate system based on a common currency basket, this means that a central rate of a currency towards the ECU has to be adjusted. According to the Resolution the adjustments of central rates are subject to mutual agreement, which in practice meant that the consent of the finance ministers of all member states participating in the ERM was necessary. The government's and not the central bank's responsibility for currencies realignment has two negative effects. First, the process for reaching the mutual accord is long lasting, while, on the other hand, the quick reaction is necessary in order to prevent a currency crisis. Secondly, there is a danger that one or more states will prevent the possibility to adjust the central rates out of the non-economically motivated reasons.21

Therefore, in order to enable efficient exchange-rate management the competence for the adjustments of central rates should be shifted to the national central banks, which should at the same time be given the independent status from the instructions from the governments. The Maastricht Treaty did envisage that during the second transitional period, national legislation should be revised in a way to secure the independent status of national central banks. However, the Treaty obligation is to create such a legal situation before the start of the third stage of the monetary union, so that such legislation can be passed in the last moment before the creation of the European Central bank. Whether the political competence over the exchange rates adjustments will be eliminated during the transitional period, will therefore, depend on the speed of the adjustment of legislation in individual member states.

The proof of the inability of the EMS to respond adequately to the massive market attacks was the crisis in 1992/1993. The final outcome of this crisis, beside the fact that two currencies left the ERM, was the widening of the fluctuation margins (from +/- 2.25% to +/-15%). This turned the EMS into a system which is closer to the floating exchange rates than fixed exchange-rates system. If we compare the present situation with the Padoa-Schiopa's quartet mentioned at the beginning of this paper, it seems that the solution accepted for the transitional period in a situation in which it was not possible to give up the national monetary sovereignty, was to give up the fixity of exchange rates.

In 1994 the second transitional stage of EMU has started. As envisaged by the Maastricht Treaty, the new monetary body - European Monetary Institute (EMI) was created, with the role to strengthen the coordination of national monetary policies, to strengthen the cooperation between the national central banks, and to monitor the functioning of the EMS. Its establishment, however, did not bring any change to the mechanisms of monetary policy and exchange rate management. It merely offered the new body within which the monetary consultations could be held. EMI has no power for bringing the legally binding decisions, which would create legal commitment for the member states. The recommendations the EMI might give to the states are again subject only to political sanctions.

The creation of the EMI had no implications on the functioning of the EMS. It even meant the confirmation of the August 1993 decision on the "temporary" widening of the fluctuation bands. The EMI's president Alexandre Lamfalussy considers that the new bands should be retained in order to prevent new market speculations.22 What influence would this have on one of the convergence criteria of the Maastricht Treaty still remains to be decided. One of the criteria which every state has to fulfil to enter the monetary union, beside those relating to the convergence of inflation rates, interest rates, budgetary deficit and public debt, is "the observance of the normal fluctuation margins provided for by the Exchange Rate Mechanism of the European Monetary System, for at least two years, without

devaluing against the currency of any other Member State."23 What will be regarded as a "normal fluctuation margin" - the old narrow margins or the new very wide ones? The recent statements of the European ministers of economy and finance give us the reason to believe that the wide bands will be regarded as "normal".24

CONCLUSIONS

The political decision to take another step in the process of economic integration in the EC was sealed by the signing and the ratification of the Maastricht Treaty. It provided for a legal basis for forming the monetary union among the members of the European single market. But, while stating the precise economic criteria which are to be fulfilled before making a new step in the integration, the new Treaty did not give a clear institutional and legal framework which would help in achieving these criteria. The old EMS, unadapted to the new market possibilities, remained the framework for maintaining the monetary stability.

Lacking the appropriate solutions in the Maastricht Treaty for the transitional period, it was the market that finally forced the reform of the EMS. As the Maastricht Treaty missed the opportunity to make a reform of the EMS and bring it under the Community legal order, turning it into the enforceable legal instrument capable for paving the way towards the monetary union, the market caused a de facto disappearance of the fixed exchange rate system, changing the envisaged route to monetary union. The starting position for the switch to the irrevocably fixed exchange rates is not any more a system of fixed but adjustable exchange rates, but a system of the practically floating exchange rates.

The stability of the European currencies during the transitional period, which is regarded as a precondition for successful creation of the monetary union, will depend on the policy orientation of individual member states, and their commitment to monetary union. In such a situation there may be enough exchange rate stability to proceed to the monetary union straight from the wide margins.25 It is true that most of the old ERM currencies have returned to the narrow, not any more official fluctuation margins,26 which shows that the exchange rate stability is still perceived as an important element for achieving the monetary union.

But, as much as this is true for some states of the EU, it is not for all of them. Only ten out of 15 members of the EU participate in the exchange rate mechanism of the EMS. Several states are clearly not the candidates for the monetary union not even in 1999, and two states (UK and Denmark) were given the possibility to opt out from the monetary union. The question which arises is, therefore, whether the monetary union is really a common future of the European Union? Or is it just a first, out of many common policies, which will be optional for present and future members of the European integration? The picture of a multispeed or a variable geometry Europe is becoming today more and more realistic. And if the alternatives are either stagnation or even a disintegration, then this is not necessarily a bad solution for the future of Europe.

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