# Topic Page: European Monetary System

Definition: **European Monetary System** from *The Hutchinson Unabridged Encyclopedia with Atlas and Weather Guide*

Arrangement to coordinate monetary policy and exchange rates in the countries of the European Community. It was launched in March 1979, based on the Exchange Rate Mechanism (ERM), but ceased to function with the advent of the euro as the single European currency.

Image from: **Crowds gather in Frankfurt, Germany, for the...** in *Big Ideas Simply Explained: The Economics Book*

Summary Article: **European Monetary System**
From *The Columbia Encyclopedia*

arrangement by which most nations of the European Union (EU) linked their currencies to prevent large fluctuations relative to one another. It was organized in 1979 to stabilize foreign exchange and counter inflation among members. The European Currency Unit (ECU), which also was established in 1979, was the forerunner of the euro. Derived from a basket of varying amounts of the currencies of the EU nations, the ECU was a unit of accounting used to determine exchange rates among the national currencies. Periodic adjustments raised the values of strong currencies and lowered those of weaker ones, but after 1986 changes in national interest rates were used to keep the currencies within a narrow range. In the early 1990s the European Monetary System was strained by the differing economic policies and conditions of its members, especially the newly reunified Germany, and Britain permanently withdrew from the system.

In 1994 the European Monetary Institute was created as transitional step in establishing the **European Central Bank** (ECB) and a common currency (the euro). The ECB, which was established in 1998 and has its headquarters in Frankfurt, Germany, is an official institution of the EU and is responsible for setting a single monetary policy and interest rate for the eurozone nations, in conjunction with their national central banks. Like the U.S. Federal Reserve, it is charged with controlling inflation; unlike the Federal Reserve, it is not also mandated with promoting employment. Also, unlike most central banks, it does not function as a lender of last resort for the eurozone governments. Late in 1998, Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain cut their interest rates to a nearly uniformly low level in an effort to promote growth and to prepare the way for a unified currency.

At the beginning of 1999, the same EU members adopted a single currency, the **euro**, for foreign exchange and electronic payments. (Greece, which did not meet the economic conditions required until 2000, adopted the euro in 2001.) The introduction of the euro four decades after the beginings of the European Union was widely regarded as a major step toward European political unity. By creating a common economic policy, the nations acted to put a damper on excessive public spending, reduce debt, and make a strong attempt at taming inflation. Euro coins and notes began circulating in Jan., 2002, and local currencies were no longer accepted as legal tender two months later. Of the EU members admitted since 2004, seven—Slovenia (2007), Cyprus and Malta (2008), Slovakia (2009), Estonia (2011), Latvia (2014), and Lithuania (2015)—have since adopted the euro.

Of the European Union members—Denmark, Great Britain, and Sweden—that did not adopt the euro when it was introduced perhaps the most notable is Britain, which continued to regard itself as more or less separate from Europe and in 2016 voted in a referendum to leave the EU, but in all three nations there was strong public anxiety that dropping their respective national currencies would give up too much independence. Danish voters rejected adoption of the euro in a referendum in 2000; the vote was seen as strengthening euro opponents in Britain and Sweden.

The budget-deficit ceilings established in the process of introducing the euro have been violated by a number of countries since 2001, in part because of national government measures to stimulate economic growth. In 2003, EU finance ministers, faced with the fact that economic downturns had put France and Germany in violation of the ceilings, temporarily suspended the pact. The European Commission challenged that move, however, and the EU high court annulled the finance ministers' decision in 2004.

The global financial crisis of 2008–9 revealed by 2010 a number difficulties in the common monetary system. In the crisis and its aftermath nations could not resort to expanded government deficits as a means to revive their economies; instead, soaring deficits forced significant recessionary government austerities on Greece, Ireland, Spain, Portugal, and other nations. Lacking national currencies, these nations also could not resort to devaluation. The budget shortall and government debt in Greece in particular strained the monetary union and the stability of the euro as eurozone nations (Germany especially) agreed only with difficulty on measures designed to assist Greece and support the euro. The delay in acting contributed to an increase in the cost of aiding Greece, and forced EU nations, along with the International Monetary Fund, to pledge $950 billion in loan guarantees and other measures to aid financially troubled eurozone nations and support the euro. Ireland and Portugal also ultimately were forced to seek international financial assistance. In Dec., 2010, EU nations agreed to establish the European Stability Mechanism (ESM), a permanent fund to aid financially troubled member nations that came into being in Oct., 2012.

As the eurozone financial crisis continued into 2011, threatening Spain and Italy as well, EU governments agreed to strengthen the powers and increase the aid funds and to additional efforts, including significant losses on Greek debt, to stabilize Greek finances. In Dec., 2011, an EU accord was reached (with Britain as the only clear nonparticipant) to more strictly enforce the deficit and debt ceilings required of eurozone and other EU members through national constitutional amendments and EU sanctions. The agreement was codified in a treaty signed in Mar., 2012, by all EU nations except Britain and the Czech Republic; later that month, the amount of funds available to aid troubled nations was increased. Spain and Cyprus subsequently announced plans to seek international financial assistance. In July, 2012, EU nations agreed to establish a financial supervisory authority under the ECB to oversee the eurozone's largest banks and also to allow bailout aid directly to those banks (instead of to them through their national governments) once the oversight body was created.

By mid-2013 the ongoing eurozone crisis had produced prolonged recession and record average unemployment in the region (and extremely high unemployment in Greece and Spain). In 2014 the threat of deflation and resurgent recession led the ECB to adopt additional measures designed to encourage lending and reduce the value of the euro; these measures continued through 2017. The ECB subsequently began to emphasize the need to tackle high unemployment and improve economic competitiveness in the eurozone nations. Greece's persistent economic problems and its new government's desire for the easing of bailout conditions led to a new crisis in mid-2015 and to the demand by Germany and other eurozone nations for greater austerities and changes in Greece. The crisis also undermined the sense of common European purpose and exposed divisions within the EU.

See James, H. , Making the European Monetary Union (2012);.
Brunnermeier, M. K. et al., The Euro and the Battle of Ideas (2016);.
Stiglitz, J. , The Euro: How a Common Currency Threatens the Future of Europe (2016).



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## APA

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## MLA

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