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EUROPEAN MONETARY POLICY

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Abstract:

This paper analyses the impact of the monetary policy of the European Union (EU) focusing on key instruments and strategies, and the challenges that the monetary policy of the EU faces, including the divergent economic performance of the member states, the lack of a fiscal union and the impact of global economic events. Through a theoretical review, the efficiency of the current policies is considered, as well as perspectives for future development, including the possibility of improving the coordination of monetary policy within the EU and its relationship with other global economic players.

This paper also analyses the EU's aspiration towards the creation of a common market and the introduction of a common currency – the euro – as a central pillar of economic integration. The impact of the single currency on price stability, competitiveness and trade flows within the EU is also studied, as well as the advantages and disadvantages of the Eurozone, especially in the light of recent economic crises. Finally, analysing the theoretical and practical experiences so far, the perspectives for the future of the European monetary policy and possible reforms aimed at strengthening the economic integration and stability of the Eurozone are considered.

Keywords: *monetary policy, European Union, Eurozone, convergence, exchange rate mechanisms*

JEL classification: E40,42

INTRODUCTION

The European Union has undergone numerous challenging changes and reforms throughout history to become what it is today. Today, the European Union has 27 member states, 20 of which belong to the Economic and Monetary Union (EMU), i.e. the euro is their official currency. The Eurozone has not yet covered all EU member states, but

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some are already on the path to accession, whereas others do not yet meet the conditions. The conditions that need to be fulfilled are called convergence criteria, which each member of the European Union must fulfil in order to be ready for the common currency, the euro.

The European Union is a unique form of regional integration of European countries. The European Economic and Monetary Union (EMU) operates within the EU, originally an economically and today a politically unique union where centralised monetary policy and decentralised macroeconomic and structural policies are combined when implementing economic policy. The EMU is actually a more advanced level of economic integration of the European Union based on the common market and using a single currency, the euro. The aspiration towards a common market and a common, single currency lies, among other things, in solving the problem of fluctuating exchange rates between the currencies of the member states, which to a large extent restrains the capital market itself and, naturally, prevents the common market from completely uniting a single, common internal market. The EMU therefore represents a single market with a single currency managed by a single central bank.

There are many goals of the monetary policy itself, and it is firstly the creation of high employment rate and economic growth, as well as the stability of prices, interest rates and financial markets, and the achievement of stability on the foreign exchange market. The Maastricht Treaty was signed in order to achieve all these goals and for the EMU to function in the best possible way, i.e. to stop the monetary uncertainties of the single market. The Maastricht criteria, i.e. nominal convergence criteria, represent certain economic conditions that EU member states must fulfil in order to enter the third phase of the EMU, i.e. the introduction of the euro. The fulfilment of these criteria would result in a good economic policy, i.e. they lead to actual convergence. However, in the case of new member states, meeting the criteria often leads to problematic situations, since nominal convergence does not automatically mean actual convergence. Namely, the theory of the optimal currency area highlights the importance of actual convergence, which in fact refers to the similarities of the actual structure and business cycles in countries that introduce the euro. Considering that the new countries differ greatly in terms of economic development as well as in the way the market structures function, many existing member countries have been having problems meeting these criteria for years. More specifically, the reason for their non-fulfilment is largely fiscal legacy, worse economic situation

and various other legal problems, therefore there is a conflict in these countries between nominal and actual convergence. For example, the great global economic crisis of 2008, as well as the latest economic and health crisis caused by the COVID-19 pandemic, showed all the weaknesses of the current level of integration in the EU. These crises have shown that in order to achieve sustainable growth, changes within the monetary and fiscal components are necessary, i.e. structural reforms of nominal convergence and all EMU monetary policy instruments are necessary.

Like any process and system, monetary unions have many advantages as well as costs. As for the ratio between the advantages, i.e. between the benefits and costs of the monetary union, they depend on various disturbances in the foreign exchange markets and on the possibilities of the exchange rate to absorb asymmetric shocks and the like. In particular, in the European Union, the benefits and costs of the monetary union will depend on the future processes of both political and economic integration.

In addition to the introduction of the euro, the Economic and Monetary Union also means the harmonization of the economic policies of the EU member states as well as the joint design of the implementation of the economies of the member states, supporting the growth of the economy, securing jobs and the economic competitiveness of the European Union at the global level.

What should be emphasised is that all EU member states harmonise their economic policies, with the aim of improving and contributing to the economic goals of the European Union. However, those countries that have managed to go one step further, i.e. those that replaced their national currencies with the euro, form and belong to the euro area. The euro was introduced in 1999, and at that time the euro area consisted of eleven out of the then fifteen members of the European Union.

1. INSTITUTIONS OF THE ECONOMIC AND MONETARY UNION

The institutions of the economic and monetary union are mainly in charge and responsible for defining, regulating and monitoring the monetary policy, as well as the rules related to issuing the euro and ensuring price stability in the EU. These institutions are: The European Central Bank (ESB), the European System of Central Banks (ESCB), the Economic and Financial Committee, the Eurogroup and the Economic

and Financial Affairs Council (Ecofin). According to the Treaty on European Union, the main goals of these institutions are as follows:

- to complete the establishment of the internal market by eliminating exchange rate fluctuations and costs related to foreign exchange transactions and the costs of protection against the risk of exchange rate fluctuations;
- to ensure comparability of costs and prices within the EU, which helps consumers, encourages intra-EU trade and facilitates business;
- to strengthen the monetary stability and financial strength of the EU:
  - by preventing, by definition, any possibility of speculation with EU currencies;
  - by ensuring that the new currency is largely impervious to international speculation through the economic dimension of the monetary union thus established;
  - by enabling the euro to become an important reserve and payment currency.

The European System of Central Banks (ESCB) consists of the European Central Bank and 27 national banks, members of the European Union. The primary goal of the ESSB is to ensure price stability and, if possible, to support the economic policy of the European Union as part of this goal. The ESSB works in accordance with an open economy and a free market that supports the sustainable use of resources.

Every modern country has its own national central bank that manages its finances and monetary policy. Thus, the European Central Bank, which has a central role in the Eurosystem, has become the central bank for the 19 EU member states that have accepted the euro and thus entered the euro area. The European Central Bank is a separate and distinct institution within the European Union, located in the Federal Republic of Germany in Frankfurt am Main, which operates independently. Thus, the ECB can use its instruments in a way to fulfil all the duties and the main task. Although the ECB is an independent institution, it still has to answer to someone. According to the Statute of the ESRB, it reports primarily to the European Parliament, elected by the citizens of the European Union, and the Council of the EU must also be notified as a body representing the governments of the member states. The main goal of the ECB is to maintain price stability and keep purchasing power at a stable level in that area.

2. EUROGROUP

The Eurogroup is an informal body that was established with the aim of allowing the ministers of the Eurozone member states to discuss certain responsibilities that they all have in common regarding the euro. The Eurogroup's main task is to ensure close coordination of economic policies among Eurozone member countries, as well as to encourage conditions for strengthening economic growth, since policy coordination among Eurozone countries is key to ensuring stability in the entire Eurozone. The discussions of the Eurogroup therefore cover specific issues related to the euro, as well as broader topics that have an effect on the fiscal, monetary and structural policies of the member states of the euro area. The Eurogroup strives to identify common challenges and find common approaches to these challenges. It is also responsible for the preparation of euro area summit meetings and other related activities. The role of the Eurogroup is defined in Protocol no. 14 of the Treaty of Lisbon.

The Eurogroup regularly discusses the economic situation and prospects in the euro area, the budgetary policies of the euro area member states, the macroeconomic situation in the euro area, structural reforms with the potential to increase growth, issues related to maintaining financial stability in the euro area, preparations for international meetings and the enlargement of the euro area. In addition, the Eurogroup can hold preliminary discussions on Council decisions that would apply only to euro area member states. When the Council makes such decisions, only ministers from the member states of the euro area vote. The Eurogroup is also discussing the terms of financial assistance for Eurozone member countries in serious financial problems.

3. CONVERGENCE CRITERIA

The Treaty on European Union is also known as the Maastricht Treaty, named by the city in the Netherlands where it was signed and ratified on 7 February 1992 by the representatives of 12 member states, and thus entered into force on 1 November 1993, by which the European Union took the form it is known for today. The treaty laid the foundations for the creation of the euro as a common currency for the member states, and closer cooperation between them was established. These rules ensure the stability of the prices of the euro area, so that when a new country joins, they will remain in their equilibrium. The following specific rules were adopted, according to the Treaty on European Union:

- level of national debt,
- general government deficit, in % of GDP (up to -3.0%), 39
- public debt, in % of GDP (up to 60.00%),
- price stability
- inflation (average of the three countries with the lowest inflation plus 1.5%),
- long-term interest rates (average of the three countries with the lowest interest rate plus 2.00%),
- exchange rate (European exchange rate mechanism – ERM II).

The first rule, i.e. the convergence criteria, states that the inflation rate should not exceed 1.5 percentage points based on the average of the inflation rates of the three countries with the lowest inflation rates. A country that wants to join the euro area must therefore harmonise its price stability. According to the authors, the influence of the German Bundesbank (the central bank of the Federal Republic of Germany), which was anti-inflation oriented, was the most suitable for this criterion, which proved to be a resounding success. Thus, in order for prices to remain stable upon the entry of a new country into the euro area, it is forced primarily to harmonise its own prices, i.e. their stability. Because if a country with unstable prices and high inflation were accepted as a member of the euro area, the country with a lower inflation level would create a loss due to a higher average inflation level. According to the Protocol on Convergence Criteria, inflation is measured by the consumer price index in comparison, taking into account differences in national definitions. Therefore, the representatives of the euro area countries together at the Governing Council agreed with the ECB on this very criterion.

The second and third convergence criteria refer to the budget deficit being less than 3% of the total gross domestic product. The public debt is less than 60% of the total gross domestic product. The countries within the European Union clearly lead their own fiscal policies and thus there are large gaps between these policies. There are countries that have very low indebtedness, which results in their long-term management of fiscal political issues, while on the other hand, there are countries that have high indebtedness as a result of the way they conduct fiscal policies. The aim of these highly indebted countries is to increase the inflation rate so that the actual debt is lower. In order to reduce the debt and keep inflation, i.e. prices stable, the future members enter the European Exchange Rate Mechanism (ERM II) system.

The fourth convergence criteria is the stability of the exchange rate and its maintenance within the limits of the exchange rate mechanism (ERM 2) of +/-2.25%. Fluctuations under ERM II have been expanded from +/-2.25% to +/-15%, and all fluctuations stronger than the above are sanctioned by the European Commission. This criterion also requires the future member states to adhere to a transparent exchange rate policy. Thus, according to the ERM II, the country must be part of the mechanism for a minimum of two years before joining the euro area.

The fifth and last convergence criterion states that in the period of one year before the final long-term check, interest rates must not be more than 2 percentage points in relation to the average rate of long-term interest rates of the three member countries that record the lowest inflation rates and the lowest long-term interest rates. The long-term interest rate is calculated according to the Protocol on Convergence Criteria as an arithmetic mean during the last twelve months for which the Harmonised Index of Consumer Prices (HCIP) is available. HCIP measures the behaviour of prices of goods and services purchased by private households.

4. ANALYSIS OF NOMINAL CONVERGENCE IN NEW EMU MEMBER STATES

The new EU member states are those countries that joined the union in the fifth and sixth enlargements. The fifth round of European Union enlargement took place in two phases. The first phase was in 2004, when the following countries joined the EU: Cyprus, Czech Republic, Estonia, Lithuania, Latvia, Hungary, Malta, Poland, Slovakia and Slovenia. Romania and Bulgaria joined in the second phase of this round in 2007. Croatia joined in the sixth round, in 2013.

The new member countries achieve different results in the process of convergence, which means that they are not equally ready for a single monetary zone, since some have not, for example, tied the exchange rate of their national currency to the euro, some have high inflation, and some do not meet the fiscal criteria (Kandžija, Cvečić, 2008, p. 196). Depending on the specific macroeconomic and microeconomic conditions, the country applies a specific exchange rate system, which has the function of achieving key macroeconomic goals and promotes the process of actual convergence, i.e. the development and transformation of their economies in order to stimulate the successful process of their

economies reaching the level that is present in the EU (Kandžija, 42 Cvečić, 2008, p. 196).

Exchange rate stability can be achieved through a fixed regime, but there is a risk of a rapid appreciation of the actual exchange rate and a high deficit of the current account of the balance of payments due to the high inflation accompanying the catch-up process. In such circumstances, foreign direct investments and flexible labour markets, as well as stable fiscal and monetary policy, can be helpful. Flexible regimes can enable the gradual appreciation of the actual exchange rate and the achievement of the nominal inflation criterion without restrictive monetary and fiscal policies (Kandžija, Cvečić, 2008, p. 196).

5. EUROPEAN EXCHANGE RATE MECHANISM

The European Exchange Rate Mechanism is one of the convergence criteria that must be fulfilled by the countries acceding to the euro area in order to become full members. They must participate for a minimum of two years so that the fluctuations are within the permissible limits. ERM II thus represents a multilateral agreement between a member state of the European Union, i.e. the country acceding to the euro area, the existing members of the euro area, the ECB and current participants in the exchange rate mechanism.

The European Exchange Rate Mechanism (ERM II) has been in force since 1 January 1999, and it limits the maximum fluctuation of the exchange rate linked to the euro to +/-15%. Member states can apply, when they meet the convergence criteria, to join the European Exchange Rate Mechanism. Since it is an obligation to be part of the ERM II, countries that have not yet joined the Exchange Rate Mechanism are not able to introduce the euro as an official currency for the next two years.

Each country, as predicted by the European Exchange Rate Mechanism, had an exchange rate that was linked to the euro in a permissible fluctuation, according to which the final exchange rate was finally adopted for the introduction of the new currency, the euro, as an official currency of the country.

6. EURO – COMMON CURRENCY OF THE EUROPEAN UNION

The euro as a common currency was introduced in 1999 in eleven member states, and today it is used by 20 of the 27 member states, with two countries on the official path to introducing the euro. It is used by more than 340 million Europeans, making it one of the most important currencies in the world.

Euro banknotes and coins

There are two series of euro banknotes in circulation. The first series comprises seven different denominations: €5, €10, €20, €50, €100, €200 and €500. The second series, or Europa series, has the same denominations, except for the €500 denomination, which ceased to be issued on 27 April 2019. The new Europa series began to be issued with new €5 banknotes in 2013. This was followed by the new Europa banknotes of €10 in 2014 and €20 in 2015. Two years later, in 2017, €50 banknotes were put into circulation, and the Europa series was completed in 2019, when new €100 and €200 banknote series were put into circulation. Euro banknotes are under the jurisdiction of the ECB.

Unlike two series of banknotes, according to the ECB (2020), coins are produced in only one series and consist of eight denominations of 1 cent, 2 cents, 5, 10, 20 and 50 cents and €1 and €2. The front side of euro coins does not differ by country, while the so-called national side on the back refers to the issuing country. The peculiarity of the coins is that, according to the ECB (2020), issuing countries may issue two commemorative coins per year. They do not differ on the front side, but they are allowed to issue a special, national side, which does not prevent their use in other member states. Unlike banknotes, euro coins are under national jurisdiction and the European Commission is notified of changes to the national side.

7. EMU IN THE FINANCIAL GLOBAL CRISIS

The financial crisis that gripped the world in 2008 brought the euro into crisis in 2010, as shown by the fact that in the countries of the Eurozone, the GDP per capita in 2015 was estimated at a lower value than it was the year before the outbreak of the crisis, i.e. in 2007 (Stiglitz, 2017, p. 25).

Every financial crisis is a test for the functioning of the EMU. The problems faced by the members of the EU and especially the Eurozone are, on the one hand, influenced by the world crisis, but also a reflection of the weakness of their economic policies. In the Eurozone, there were visible phenomena that characterised the developed countries of the world, such as low yields on bonds as well as a slight difference in the yields on bonds of different countries of the European Union, low nominal interest rates, an increase in real property prices. However, the difference compared to the implications of the crisis in the USA exists because the market for subprime loans was not developed in the EU, so the banks invest much less in securities, except in certain special products such as covered bonds. The securities investment market is better regulated in Europe than in the USA (Kersan-Škabić, 2015, p. 240).

A huge drop in economic activity, a large increase in unemployment, the weakening of public finances, a drop in overall productivity, and an increase in public debt are all the results of the crisis. Furthermore, considering that the countries do not have the same level of economic and social development and since the new members are largely dependent on the capital of the old ones, the crisis did not affect all the members of the European Union at the same time. The causes of the crisis in the EU were certainly partly linked to the causes of the global financial crisis, but they also showed certain specificities of the EU member states. The euro suffered major negative consequences, which were reflected in the drop in value due to excessive consumption, which further increased and worsened the situation even more due to the impossibility of settling debts in Ireland, Portugal and Greece.

Article 122 of the Treaty on the EU (Treaty of Lisbon) states that when an individual member state faces difficulties as a result of natural disasters or exceptional circumstances beyond its control, the Council of Ministers, at the proposal of the Commission, can grant a loan to such a country under clearly defined conditions. This can lead to a situation where countries that are not part of the Eurozone are forced to help Eurozone countries that are facing difficulties, and the amount of aid depends on the size of the country in crisis and the amount of its debt. The escalation of the crisis in certain members of the Eurozone points to a large number of unresolved problems at the very centre of European politics. (Kersan-Škabić, 2015, p. 243) The international aspect of the problem in Greece, Ireland and Portugal, which were really put into a difficult situation by the 2008 financial crisis, lies in the centralised monetary policy of the Eurozone, which had no counterbalance in the fiscal policy, whose only

common instrument is the EU budget, which represents just over 1% of the EU GDP, and is aimed at financing agricultural subsidies as well as regional development projects. The introduction of the euro led to a drop in interest rates, from which large countries profited more, whereas in small countries they caused excessive consumption and borrowing. The peripheral countries recorded deficits in the balances of current transactions, which directed savings from co-financed countries, for example from Germany, to less developed growing economies. The large availability of cheap loans led to an increase in demand for real assets and a high rise in real property prices in growing economies, and at the same time represented an area of strong growth in the financial sector of developed countries.

This was the situation after the global crisis of 2008. After the world recovered from this crisis, a new crisis came, caused by the coronavirus pandemic, which affected all areas of human life, and the consequences of which are felt and will probably be felt long after the end of the crisis itself. Already in the first days of the crisis, it was noticeable that the situation in the European Union has not changed significantly since the last elections. The disagreements about who, when and to what extent should provide joint assistance intensified again. Since the leaders of the European Union at the very beginning of the outbreak of the pandemic failed to overcome the divisions between the countries of the North and the South, a consensus regarding the loans as well as the request for the investment fund was still not reached not even months later, i.e. until early April 2020. However, in some way, solving the problem has been left to the national governments, which were "allowed" to invest in their economy as much as they think is necessary for its stability. One positive aspect of this entire situation related to this decision of the Commission, was that it has given the national governments room for fiscal intervention, since the restrictions related to public debt and fiscal deficit have been loosened. However, the European Central Bank reacted somewhat faster than the European Commission, and in late March 2020, it published recommendations related to the distribution of dividends during the pandemic. The aim of these recommendations was primarily to preserve and strengthen the capital of institutions dealing with loans, all so that they could, if necessary, finance small and medium-sized enterprises, large corporations and households during and after the shock of the crisis itself.

The health and economic crisis caused by the COVID-19 pandemic has become a major burden on public finances. In order to improve the

situation, already in March 2020, the Council implemented the "general escape clause from the Stability and Growth Pact". The aim of this was primarily to provide member states with a certain period of time in which they could increase their public debt outside the restrictions of fiscal rules. Almost at the same time, the European Central Bank launched a hasty purchase program, which included the acquisition of huge amounts of government debt on the secondary markets, which would ensure market liquidity. However, it should be emphasised that although the amounts insured are very high, the mentioned program is still time-limited.

7.1. Eurozone structural reforms and the future of EMU

Reforms of the structure of the Eurozone itself should aim at an economic system that can simultaneously achieve full employment and strong growth in each member state, with a sustainable export deficit in the absence of a floating exchange rate and independent monetary policies. A fundamental commitment from the Eurozone is needed to maintain an economy at full employment. Markets by themselves will not maintain full employment and they are usually not stable. In the absence of state intervention, unemployment can become permanent and very unstable (Stiglitz, 2017). Without appropriate reforms of the Eurozone structure, i.e. its institutions, rules and regulations, the return to full employment would lead to unsustainable imbalances between imports and exports.

CONCLUSION

The Eurozone needs to be reformed so that all countries in the Eurozone can achieve and maintain full employment. The current structure of the Eurozone does not allow this, because although the programs imposed on countries in crisis intend to eventually return full employment to the country, that path is extremely expensive and uncertain.

The enlargement wave is still not over, and in order to meet the nominal convergence criteria, countries must first join the ERM II. Although it is quite difficult to meet the mentioned criteria, their fulfilment will certainly have positive effects on the new member states. The new members will actually be forced to adjust their fiscal policy even more by quickly entering the European Monetary Union, and in fact a faster entry is much more positive than a later entry into the Eurozone. Namely, delayed acceptance of the euro brings numerous financial expenses,

leads to even higher public debt, higher interest rates, etc. and in fact, later entry into the EMU, in addition to these higher fiscal costs, can also lead to a certain risk of jeopardising and reducing their financial and macroeconomic stability.

Joining the EMU should serve the countries as an additional, positive stimulus for improving their fiscal discipline, and in fact, considering certain problems faced by old members, such as the aging of the population and the like, it would even be desirable to strengthen the criteria.

MONETARNA POLITIKA EU

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Apstrakt:

Ovaj rad analizira uticaj monetarne politike Evropske unije (EU) fokusirajući se na ključne instrumente i strategije, te izazove s kojima se monetarna politika EU suočava, uključujući divergentne ekonomske performanse članica, nedostatak fiskalne unije i uticaj globalnih ekonomskih dešavanja. Kroz teorijski pregled, razmatra se efikasnost dosadašnjih politika, kao i perspektive za budući razvoj, uključujući mogućnost unapređenja koordinacije monetarne politike unutar EU i njenog odnosa s drugim globalnim ekonomskim igračima.

U radu se analizira i težnju EU ka stvaranju zajedničkog tržišta i uvođenju zajedničke valute, eura, kao centralnog stuba ekonomske integracije. Proučava se i uticaj jedinstvene valute na stabilnost cijena, konkurentnost i trgovinske tokove unutar EU, kao i prednosti i nedostaci eurozone, posebno u svjetlu nedavnih ekonomskih kriza. Na kraju, analizirajući dosadašnja teorijska i praktična iskustva, razmatraju se perspektive za budućnost evropske monetarne politike i moguće reforme usmjerene ka jačanju ekonomske integracije i stabilnosti eurozone.

Ključne riječi: *monetarna politika, Evropska unija, eurozona, konvergencija, tečajni mehanizmi*

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