Understanding **the Economic and Monetary Union**

Council of the European Union

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Understanding **the Economic and Monetary Union**

Table of Contents

What is the Economic and Monetary Union?

The **Economic and Monetary Union** (EMU) is an essential part of the European integration process. The EMU contributes to economic stability, balanced economic growth, high employment and sustainable public finances in the EU Member States.

As its name suggests, the **EMU is composed of two main elements: economic policy** (the coordination of Member States' national economic and fiscal policies) and **monetary policy** (which involves using the single currency (the euro) and the pooling of sovereignty over monetary policy).

All EU Member States are part of the economic union. They have full control of their economic and fiscal policies, but they take their decisions in close coordination, on the basis of a set of EU rules and recommendations. This coordination takes place via a process called the European Semester, the name of which reflects the fact that the key steps in the process – such as assessing each Member State's economic situation and agreeing on individual recommendations – are taken in the first semester of each year. Member States coordinate through the European Council (where Heads of State or Government meet) and the Council of the European Union (which is composed of ministers).

Member States become members of the monetary union after they have adopted the euro as their currency. To be able to join the euro area, they need to make sure their economies have sufficiently converged with the economies of those Member States that already use the euro (i.e. they have reached levels of fiscal, financial, monetary and price stability comparable to those of the euro area Member States). This convergence is necessary to ensure the smooth functioning of the monetary union. Countries that would like to join the euro area therefore need to fulfil a number of conditions, known as convergence criteria, which help determine whether a country is ready to integrate into the monetary union.

Countries whose currency is the euro together form the **euro area**. They pool their sovereignty over monetary policy, which is set by the European Central Bank (ECB), an independent EU institution. The euro area Member States also hold political discussions on issues relevant to the euro in the **Euro Summit** (composed of the Heads of State or Government) and in the **Eurogroup** (an informal forum, composed of finance ministers of the euro area Member States).

The aim of economic policy coordination is to ensure the smooth functioning of the EMU, as policies pursued in one EU Member State may have a significant effect on other Member States. Such effects may be even more pronounced among the euro area Member States, whose economies are more closely knit together because of the shared currency. The policy coordination rules therefore contain a number of additional requirements for euro area Member States.

Who does what in the Economic and Monetary Union?

The roles of the main bodies involved in the EMU are as follows.

Member states adopt EU legislation in the Council, draw up their national budgets in line with the EU rules governing deficit and debt, and develop their own structural policies in relation to labour markets, pensions and capital markets.

The **European Council** sets the general political direction and priorities of the European Union. The European Council is composed of the EU leaders (Heads of State or Government) together with the President of the European Council and the President of the European Commission. The European Council meets at least four times a year.

The **Euro Summit** discusses the strategic orientations for economic policies in order to improve competitiveness and convergence in the euro area. It also discusses the institutional setup of the EMU. The Euro Summit brings together the leaders of the euro area, the President of the Euro Summit and the President of the Commission. The Euro Summit may also be held among the leaders of all 27 EU Member States. The President of the ECB also attends. The President of the Eurogroup may be invited to these meetings. In principle, the Euro Summit meets at least twice a year.

The **Council**, in its configuration as the Economic and Financial Affairs Council (the Ecofin Council), adopts EU legislation, coordinates economic policies at the EU level and decides whether a Member State may adopt the euro. It is composed of the finance and/or economy ministers of the EU Member States. The Commission and the ECB also take part in Ecofin meetings. In general, the Ecofin Council meets once a month.

The **Eurogroup** discusses policies that are relevant to the euro and the smooth functioning of the EMU. The Eurogroup undertakes preparatory work for Euro Summit meetings and is responsible for follow-up work after these meetings. It brings together the finance ministers of the euro area Member States. The Commission and the ECB also take part in Eurogroup meetings. The Eurogroup typically meets once a month, ahead of the Ecofin Council meetings.

The **Commission** proposes new EU legislation and monitors whether Member States are meeting targets and complying with existing rules, including the rules on economic governance. It also assesses the economic situation and makes recommendations to the Council on decisions to be taken.

The **European Central Bank** (ECB) is the central bank for the euro area. It decides on monetary policy, with price stability as the primary objective, including by setting the reference interest rates.

The **Eurosystem**, which comprises the ECB and the national central banks (NCBs) of euro area Member States, conducts and implements monetary policy.

The **European System of Central Banks** (ESCB) brings together the ECB and the NCBs of all EU Member States, whether or not they have adopted the euro. All of the EU Member States' central banks are ECB shareholders.

The **European Stability Mechanism** (ESM) is an international financial institution set up by the euro area Member States to help euro area countries threatened by severe financial distress. It provides financial assistance under certain conditions. It was established in September 2012. Its Board of Governors is composed of the finance ministers of the euro area Member States.

The **European Parliament** is involved in the EU legislative process in some areas of economic policy coordination, as a co-legislator together with the Council. The Council and the Commission regularly inform the Parliament about their work.

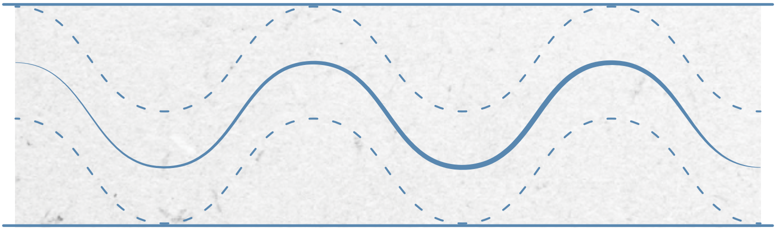
The Economic and Monetary Union: key dates and events

The **European integration process** is a gradual one, characterised by incremental steps in what remains a work in progress. It is therefore difficult to pin down a specific moment in time when economic and monetary union started, and it remains under construction today.

The Heads of State or Government of the members of the European Economic Community (EEC), the European Union's predecessor, formally launched the EMU at a European Council meeting that took place in Maastricht, the Netherlands, in December 1991. The resulting new treaty among the then Member States, known as the Maastricht Treaty, or the Treaty on European Union, contained the provisions necessary for the development of the EMU.

1970s
The first blueprint

While the 1992 Maastricht Treaty represents the formal birth of the EMU, the concept of economic and monetary union had already been developing for at least two decades. At the request of the leaders of the EEC and on the basis of a Commission initiative, the Werner Report of October 1970 presented the first blueprint for creating, in three stages, an economic and monetary union. While the plan as a whole was temporarily set aside due to the financial turbulence in the early 1970s, which was prompted by the United States terminating the convertibility of the US dollar into gold and the sharp rise in oil prices, the EEC still implemented parts of the plan, which involved designing mechanisms to stabilise exchange rates between EEC currencies and the US dollar. These included the April 1972 Basel agreement, which introduced the 'snake-in-the-tunnel' system – whose name reflects the value oscillations permitted within a bundle, as seen in the picture below – and the European Monetary Cooperation Fund, established in 1973.



Snake in the tunnel

The Basel agreement did not, however, stabilise intra-EEC exchange rates. This lack of stability was perceived as having a negative impact on internal cohesion and investment, and on trade within the EEC and with major external trading partners. This consequently led to a second attempt to establish an economic and monetary union in 1979, through the introduction of the **European Monetary System** (EMS). In the EMS, participating Member States' currencies were kept within an exchange rate mechanism with the same fluctuation bundle as the 'snake-in-the-tunnel' system, but measured against the basket of European currencies (the ecu, essentially an accounting currency) instead of the US dollar, which proved to be a more sustainable solution. The aim was to promote balanced growth based on monetary stability, and to achieve closer economic convergence between Member States.

1980s

The Delors Committee

In 1988, a committee was set up, headed by Commission President, Jacques Delors. Its aim was to pave the way for the transition from the EMS to a fully integrated monetary system, in order to promote economic integration by removing exchange rate risks within the EEC. The resulting Delors Report proposed that full economic and monetary union should be achieved in three steps.

- First, all restrictions on capital movement between Member States should be abolished.
- Second, a new monetary unit of account (the ecu/euro) should be defined, a new exchange rate mechanism created and fiscal policies coordinated.
- Third, exchange rates should be irrevocably fixed and soon afterwards national currencies would be converted to the euro.

1990s

The first steps towards the Economic and monetary union and the birth of the euro

The first step of the Delors Report was implemented just 1 year after its publication, through a June 1989 European Council decision abolishing all capital movement restrictions between Member States as of July 1990. The various elements of the second and third steps were implemented during the course of the 1990s, following the Maastricht Treaty, which formally launched the EMU project.

Convergence criteria to join the euro area

The Maastricht Treaty, among other things, outlined a number of criteria that a Member State must fulfil in order to introduce the euro as its currency. They are known as **convergence criteria**, or **Maastricht criteria** and include the following.

- Price stability. The inflation rate cannot be more than 1.5 percentage points above the rate of the three best-performing Member States.

- Sound and sustainable public finances. The Member State should not be subject to what is known as the 'excessive deficit procedure', i.e. in principle, its public deficit should not exceed 3 % of its gross domestic product (GDP, the total value of a state's production of goods, services etc.), and its public debt should not exceed 60 % of GDP.
- Long-term interest rates. The long-term interest rate must not be more than 2 percentage points above the rate of the three best-performing Member States in terms of price stability.
- Exchange rate stability. The country has to participate in the Exchange Rate Mechanism (ERM II) for at least 2 years, without significant deviations from the ERM II central rate and without devaluing its currency's bilateral central rate against the euro during that period.

Furthermore, candidates to join the euro area must also ensure that their national legislation is compatible with the treaty and with the Statute of the European System of Central Banks (ESCB) and the European Central Bank (ECB). The Treaty and the Statute provide for the independence of central banks.

All EU Member States should eventually introduce the euro, except for Denmark, which has chosen to opt out. It may nevertheless apply for membership of the euro area if it so decides.

WHAT IS THE EXCHANGE RATE MECHANISM?

The purpose of the Exchange Rate Mechanism (ERM II – the successor to the original exchange rate mechanism) is to demonstrate that a country's economy can function smoothly without recourse to excessive currency fluctuations.

When a non-euro area country enters the ERM II, its national currency is tied to the euro at a central rate that is agreed with the euro area Member States, the non-euro area countries that already participate in the ERM II and the ECB, with the involvement of the Commission. The currency is then allowed to fluctuate within the standard limit of 15 % above or below this agreed central exchange rate. Participating Member States may unilaterally commit to tighter fluctuation bands.

As participation in the ERM II is a precondition for the introduction of the euro, all EU Member States, except Denmark, are expected to join the mechanism at some stage.

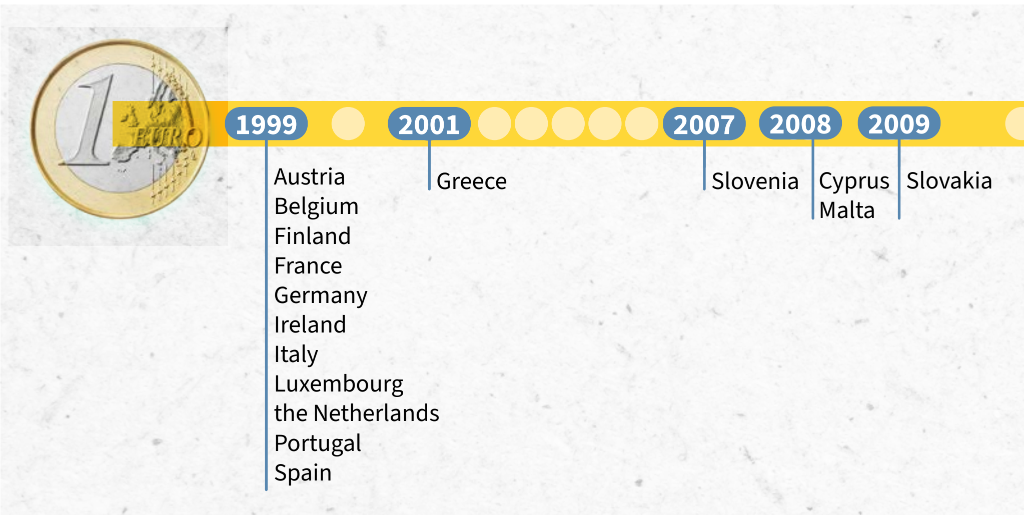
Since 2018, countries willing to join the ERM II each agree with the ERM II parties a roadmap which provides for the implementation of a number of policy commitments, including establishing close cooperation with the ECB's banking supervision arm by the time their currencies enter the ERM II.

2000s
The first years of the euro

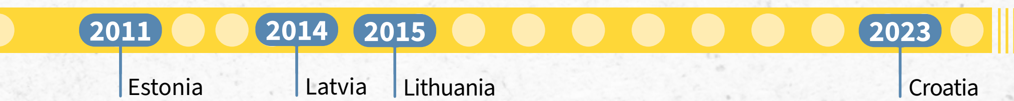
On 1 January 1999, following confirmation of their fulfilment of the convergence criteria, 11 EU Member States irrevocably fixed their exchange rates and later introduced the euro. For the first 3 years of its existence, the euro was not a fully-fledged currency – it was used as an accounting unit and for electronic payments only. Euro coins and banknotes were launched on 1 January 2002, when 12 EU Member States replaced their national currencies with the euro.

The euro makes it easier for consumers across the euro area to compare prices. Also, thanks to the euro, no exchange fees or transaction costs have to be paid when buying goods and services in other Member States in the euro area. In this way, the EMU complements the EU's single market, with its free flow of goods, services, people and capital.

Timeline of euro adoption



In the first few years following the launch of the euro, the EMU functioned smoothly and financial markets were optimistic about its prospects, resulting in low funding costs for governments, with interest rates on sovereign bonds converging among euro area Member States.



Map of the euro area

2010s

Strengthening the foundations of the Economic and Monetary Union

This optimism came to an abrupt halt with the global financial crisis of 2007–2009, which originated in the United States and triggered the Great Recession and, in 2010, the euro area sovereign debt crisis. The realisation that a number of large banks were significantly exposed to a large volume of highly leveraged risky assets that had been mispriced led to a sudden reassessment of risks. This, in turn, caused a crash in prices, hitting first financial institutions and then the rest of the economy. Soon it also affected public debt, as governments took a number of measures in an attempt to restore financial stability. In addition to introducing automatic stabilisers, they engaged in bank bailouts and used public funds to salvage the situation, which resulted in increased public deficits and debts.

Financial markets began to doubt the sustainability of some of the euro area Member States' growth models and, ultimately, the capacity of vulnerable Member States to repay their public debt. This led to rising interest rates on some government bonds and even liquidity problems for some national treasuries, adding to debt sustainability concerns and generating a vicious circle that needed to be stopped through decisive policy action.

The solutions included establishing the European Stability Mechanism, establishing a stronger economic governance framework and launching a banking union. This was followed by reflection on the completion of the EMU.

The European Stability Mechanism

Following the creation of a few ad hoc or temporary financial assistance facilities, a permanent European Stability Mechanism

(ESM) was established in 2012. Its purpose is to provide financial assistance to euro area Member States that are experiencing or are threatened by financial distress that could pose financial stability risks to the euro area as a whole or its Member States. ESM financial assistance is conditional on the implementation of sound policies. Financial assistance was provided to Greece, Ireland, Portugal, Spain and Cyprus, all of which successfully concluded their adjustment programmes.

The economic governance framework

In order to prevent and, where necessary, correct fiscal and economic imbalances, the EU overhauled **its economic governance** framework in 2011 and 2013. The new rules became known as the 'six-pack' and the 'two-pack' legislation respectively (due to the number of legal acts adopted each time as part of the package).

The commonly agreed fiscal rules set out in the **Stability and Growth Pact** (which operationalises the excessive deficit procedure provided for in the Treaty on European Union) were strengthened. As a result, euro area Member States submit their draft budgetary plans to the Commission and to the Eurogroup in autumn each year. Member States that have signed up to the intergovernmental **Treaty on Stability, Coordination and Governance** (the fiscal compact), which was concluded in 2012, have enshrined a balanced budget rule in their national legislation.

More systematic monitoring of economic imbalances was introduced and a procedure for correcting excessive economic imbalances put in place.

Euro area Member States for which serious economic difficulties have been identified and which may spill over to other Member States can be placed under enhanced surveillance, which entails tighter monitoring and information requirements and can result in a recommendation to prepare an adjustment programme. Euro area Member States that have exited an adjustment programme are subject to post-programme surveillance until they have repaid at least 75 % of the financial assistance loans they received as part of the adjustment programme.

Economic governance is implemented at the EU level through the **European Semester**. The process culminates with the Council addressing economic policy recommendations to the individual Member States and to the euro area as a whole, on the basis of Commission proposals. For euro area Member States, failure to observe the commonly agreed rules may lead to the imposition of fines.

Strengthening financial stability: the banking union

Having a well-functioning and stable banking sector is a matter of common concern, in particular for the euro area Member States. Recognising this need, the Euro Summit of June 2012 launched the **banking union**, the aim of which was to sever the links between governments and their domestic banking sectors, in order to ensure that non-viable banks are not rescued using taxpayers' money, and to promote EU financial integration.

The banking union started with the centralisation of the supervision of banks at the ECB through the establishment of the Single Supervisory Mechanism (SSM). Later on, a second pillar was added, which centralised bank resolution by creating the Single Resolution Mechanism (SRM), the central body of which is the Single Resolution Board (SRB). The SRB can, under certain conditions, make use of the Single Resolution Fund (SRF), which is financed by contributions from the banking sector, to support the resolution of non-viable banks.

The ECB and the SRB work closely with national supervisory and resolution authorities in implementing these mechanisms. They ensure consistent application of the ‘single rule book’ –financial sector regulation which euro area Member States are obliged to comply with. Participation in the banking union is mandatory for these Member States, while non-euro area Member States may join the banking union if they so wish.

Independently, the ECB added the **Outright Monetary Transactions programme** to its toolkit, in order to safeguard the smooth functioning of its monetary policy in the face of irrational fears about the reversibility of the euro.

Completing the EMU – the Five Presidents' Report

The initiatives described above strengthened the EMU, but, notwithstanding the fact that the euro area sovereign debt crisis had been overcome, at the Euro Summit of October 2014, national leaders asked the Presidents of the EU institutions to plan the next steps to improve economic governance in the euro area. They highlighted the need to develop concrete mechanisms for stronger economic policy coordination, convergence and solidarity in order to ensure the smooth functioning of the EMU. As a result, the Five Presidents' Report[1] (by the Presidents of the European Council, the Eurogroup, the European Commission, the European Central Bank and the European Parliament) was published in June 2015 and presented a roadmap setting out the different stages involved in completing the EMU, together with a series of initiatives.

A number of recommendations from the Five Presidents' Report were implemented in the months following its publication. This included establishing a **European Fiscal Board**[2], starting work on the third pillar of the banking union – a European deposit insurance scheme – and devising a capital markets union action plan.

In December 2017, leaders identified the completion of the banking union and the further development of the ESM as priority areas. In December 2018, they added a 'budgetary instrument for convergence and competitiveness' for the euro area and interested ERM II Member States. When the COVID-19 pandemic broke out in 2020, the work on the budgetary instrument was suspended, but it was used as a model for the Recovery and Resilience Facility – the centrepiece of the NextGenerationEU programme, which is designed to help EU economies recover after the severe downturn caused by the pandemic.

1 Juncker, J.-C., **Completing Europe's Economic and Monetary Union**, European Commission, 2015.

2 The **European Fiscal Board** provides the Commission with advice on and evaluation of the overall direction of fiscal policy in the euro area. This independent body is composed of five international experts whose work feeds into the Commission's work in monitoring and enforcing the Stability and Growth Pact.

2020s

Development of the Economic and Monetary Union today

In the first few years of the 2020s, two major shocks hit the EMU: the outbreak of the COVID-19 pandemic in early 2020 and Russia's unprovoked war of aggression against Ukraine. The former required temporary mobility restrictions and, inevitably, held back economic activity. Economic recovery in the wake of the pandemic stalled with Russia's invasion of Ukraine in February 2022. The war took a toll on economic sentiment and, for a while, pushed already increasing energy prices to record levels.

Member States and EU institutions reacted promptly to both crises. They provided large-scale income and liquidity support and undertook measures to mitigate the impact of the pandemic on households and businesses. National fiscal support schemes and EU energy market reforms cushioned households and businesses from the effect of high energy prices. A historic agreement on the NextGenerationEU programme, reached in July 2020 in the context of the negotiations on the EU 2021-2027 Multiannual Financial Framework, provided Member States with sizeable EU grants and loans to support the investment and reforms needed to rebuild their economies after the pandemic and succeed in their green and digital transitions. The EMU proved to be more resilient than a decade earlier.

In November 2020, the Eurogroup agreed on a more effective and flexible use of the European Stability Mechanism (ESM). The changes included a more accessible ESM precautionary credit line for Member States in need of financial support, a stronger role for the ESM in economic crisis prevention and management in the euro area, a more transparent approach to the assessment of Member States' public debt sustainability, and a credit line, or 'common backstop', to the banking union's Single Resolution Fund. This emergency fund can be used to support the resolution of failing banks, subject to certain conditions. The ESM backstop increases the credibility of the common bank resolution framework. The new features of the ESM require all euro area Member States to ratify the agreement amending the Treaty that established the ESM.

In 2021-2022, the Eurogroup resumed discussions on the completion of the banking union, looking into issues such as crisis management, deposit insurance, cross-border integration and financial stability safeguards. In June 2022, the Eurogroup agreed that, as an immediate step, work should focus on strengthening the common framework for bank crisis management and national deposit guarantee schemes. The Eurogroup committed to subsequently identify, in a consensual manner, possible further steps towards the completion of the banking union.

The EU institutions and the Member States continue the work to adapt the EMU to a changing world and modern needs. New ideas and projects are carefully examined, debated and launched. The possible creation of a digital euro as well as the revision of the EU economic governance framework are but a few examples of this endeavour.

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