European Monetary System

Introduction

The European Monetary System (EMS) was the forerunner of Economic and Monetary Union (EMU), which led to the establishment of the Euro. It was a way of creating an area of currency stability throughout the European Community by encouraging countries to co-ordinate their monetary policies. It used an Exchange Rate Mechanism (ERM) to create stable exchange rates in order to improve trade between EU member states and thus help the development of the single market. Stable money had been a key part of international economic calculations since World War II. However, by the 1980s, opinion about it was much more divided. As a result, not all countries took part in the EMS straight away, and there were deeper splits in the years to come over the role of the EU in setting monetary policy as the EMS was replaced with the Euro.

History

The EMS was launched in 1979 to help lead to the ultimate goal of EMU that had been set out in the Werner Report (1970). Since World War II, attempts had been made to maintain currency stability amongst major currencies through a system of fixed exchange rates called the Bretton Woods System. This collapsed in the early 1970s. However, European leaders were keen to maintain the principle of stable exchange rates rather than moving to the policy of floating exchange rates that was gaining popularity in the USA. This led them to create the EMS. It was not an entirely successful move because, firstly, it posed many technical difficulties in setting the correct rate for all member states, and secondly, some members were less committed to it than others. Britain didn't join the ERM until 1990 and was forced to leave it in 1992 because it could not keep within the exchange rate limits. The project, however, continued: under the Maastricht Treaty (1992), the EMS became part of the wider project for EMU that was developed during the 1990s. When the Euro came into being in 1999, the EMS was effectively wound up, although the ERM remained in operation.

How did the European Monetary System work?

The most important part of the EMS was the Exchange Rate Mechanism. This committed all member states' governments to keep their currency exchange rates within bands. This meant that no country's exchange rate could fluctuate more than 2.25% from a central point. This was designed to help create stable commerce without the fear that sudden changes in the values of currencies would dampen trade and encourage the development of trading barriers between member states.

It also created a European Currency Unit (ECU) to be used as a unit of account. Although not a real currency, the ECU became the basis for the idea of creating a single currency – an idea that was realised with the launch of the Euro in 1999.

Author: Wil James, Civitas 01/2006
Last update: Rachel Maclean, 09/2015

European Monetary System

Facts and figures

- Britain entered the ERM in 1990 at a rate of 2.95 Deutschmarks to one Pound Sterling. Many feel this rate was too high and caused Britain's rapid departure from the system.
- Britain dramatically left the ERM on 16 September 1992 (a day that became known as Black Wednesday), because it was no longer possible to keep the pound within the bands of the ERM.

Arguments

For

- The European Monetary System was important in ensuring currency stability in the European Community at a time when international markets were very volatile.
- Without the EMS the completion of the single market project would have been more difficult.

Against

- Fixing exchange rates is dangerous because unless the correct rate is set and changed appropriately, a national economy can be forced to pursue policies that are not best suited to domestic conditions simply in order to maintain international stability.
- EMS established the principle that one monetary policy can suit all member states. The events of 1992 proved that this was not the case.

"ERM was a recipe for instability… This instability produced a damaging recession."
Professor Patrick Minford, Cardiff Business School, 2002

Technical Terms

- ***Monetary policy:*** the policies employed by Governments or Central Banks to control money supply and interest rates to achieve economic goals.
- ***Exchange rate:*** the ratio in which one country's currency is valued against another.
- ***Fixed or floating exchange rates:*** in a fixed rate system all rates are set at commonly agreed levels. In a floating system they are allowed to find their own place through market pressure.
- ***Unit of account:*** an agreed measure for stating the prices of goods and services.

Links

- http://news.bbc.co.uk/1/hi/in_depth/europe/euro-glossary/1216833.stm
- http://ec.europa.eu/economy_finance/euro/emu/road/ems_en.htm

Author: Wil James, Civitas 01/2006
Last update: Rachel Maclean, 09/2015