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Chapter 1

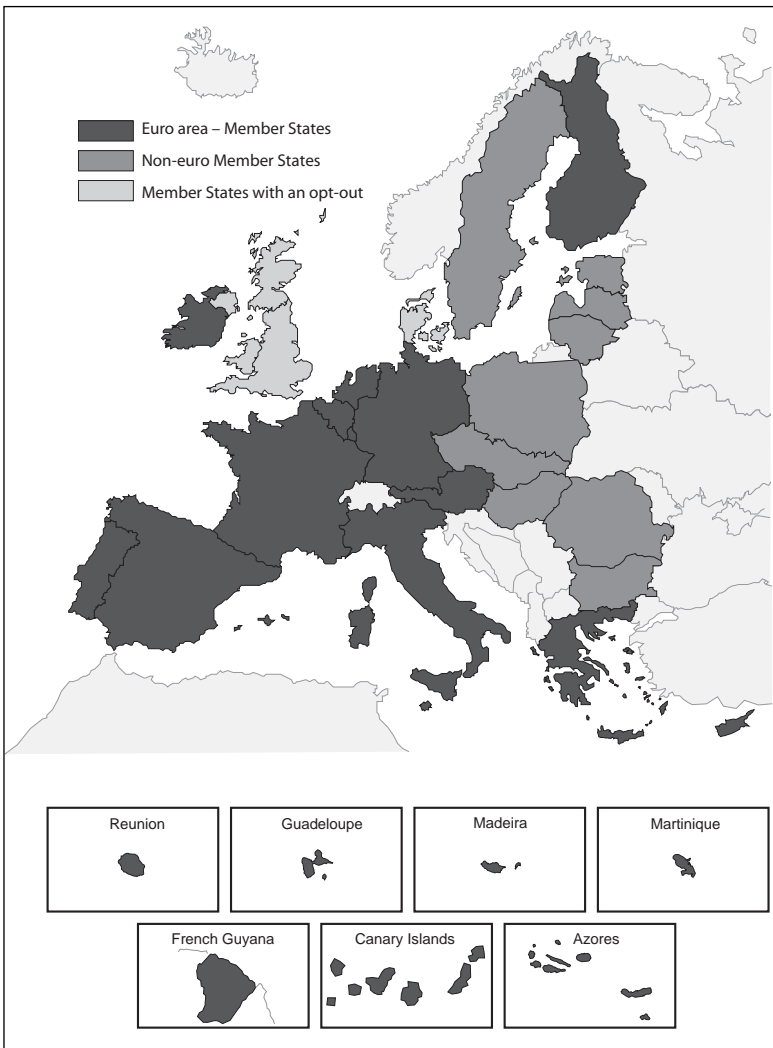
Introduction

On 1 January 1999 the European Union ushered in a new era with the successful transition from national currencies to the euro. Today the euro is one of the world's major currencies, and only the US dollar surpasses it in terms of its usage and global influence. It is currently used by 320 million people in 16 countries, and with the exceptions of Britain and Denmark (which received derogations from Economic and Monetary Union (EMU) participation), all EU Member States are eventually obliged to adopt it as their currency, thus ensuring the growth and continuation of its influence.

The single currency represents the culmination of decades of efforts to unite Europe for economic and political reasons, and is the most visible symbol of European integration today. Although the final stage of monetary union began over a decade ago, the story is far from over: the eastward expansion of the Eurozone, the rapid rise of the euro to the position of the world's number two reserve currency, and the continuing negotiations between governments and institutions in the maintenance of monetary union do not grab headlines like the signing of the Maastricht Treaty in 1992, but they are vital components of European integration as well as international monetary relations.

The purpose of this book is to provide a theoretically informed account of EMU, drawing on both economic and political research. While on the surface monetary integration has been a technical exercise dominated by central bankers, it is an intensely political process that has had a major impact on European integration and national politics. The reverse is also true, as domestic politics and European developments have reverberated to affect the monetary integration process. In particular the following questions will be addressed.

FIGURE 1.1 2008 Eurozone Member States



Source: based on Directorate General for Economic and Financial Affairs, European Commission.

1. Why did monetary union take on its particular form?

This question needs to be approached from a number of perspectives. First of all, does economic theory indicate that monetary union is either desirable or feasible? Of course, the answer is not so straightforward when (as in the case of EMU) political imperatives outstripped the pace of economic research. The economic benefits of EMU were (and still are) hotly contested, indicating the need to examine how political incentives converged with certain economic ideas to make EMU attractive to a critical mass of Member States.

Second, why did monetary union take place when it did? This is important because it points to the political incentives that were driving integration, at times allowing for a permissive consensus and other times obliging governments to take a more critical/sceptical approach, depending on the timing and how monetary cooperation interacted with other international, European and domestic political events. The idea for monetary union in Europe dates back several decades, and the fact that EMU succeeded in becoming a reality at the end of the twentieth century is related to numerous political developments. Moreover, the subsequent policies that were undertaken to support monetary union also were negotiated within a specific economic and political context which limited the options of negotiators and made certain outcomes more likely than others.

Third, to what extent were the preferences at the time institutionalized? Students of politics are well aware of the stickiness of institutions, and EMU is no different. The ability of actors to lock in preferences through institutions will determine to a large extent the room for manoeuvre that their successors enjoy, for good or ill. The institutions supporting EMU could have been constructed along a variety of different models. Why an independent European Central Bank (ECB)? Why is there no political counterweight? Why are fiscal and economic policies coordinated rather than delegated to an EU-level authority the way that monetary policy was? The institutions reflect power struggles between major actors, and such struggles may continue long after the initial agreements are signed. The 2008 French presidency of the European Union, for example, raised the issue of the ECB's accountability, stopping short of once again calling for a political counterweight to the institution but nonetheless encouraging political leaders to engage in more debate with the ECB. Despite the legal issue of the ECB's independence having been settled long ago, as a political issue it continues to attract attention.

2. Does monetary union work the way that it was supposed to?

Even though preferences may be institutionalized, this does not guarantee the successful implementation of policy. In particular when dealing with actors like sovereign nation states, the incentives for respecting international obligations may be weaker than the rewards for breaking them. In addition, the functioning of monetary union deals with not only the implementation of rules but unforeseen consequences. Despite the best efforts of academics to predict the effects of monetary integration on things like trade flows or further political integration, reality does not always correspond to theory. This book will contrast the economic and political expectations of the actors at the time with the results of the first decade of monetary union, analysing the reactions of politicians and political economists. The success of monetary union is not restricted to fulfilling original expectations, but it is important to understand why expectations were not met, both in determining which actors may be to blame (should the ECB run a looser monetary policy, for example? Or do the Member States need to implement more reforms?) and in considering the lessons that may be drawn for non-EMU states (including those who may join the Eurozone in the future as well as non-European states interested in monetary cooperation). This book therefore evaluates the success of monetary union along a number of criteria, including but not limited to the stated objectives of the founders of EMU as well as its perceived success among the citizenry of current and future Eurozone states.

3. Is monetary union harmed by not including all of the EU Member States?

Prior to the Maastricht Treaty, integration happened at the same time for all members of the European Community. Along with the creation of the European Union, the Maastricht Treaty also introduced a multi-speed Europe (or Europe à la carte, variable geometry: choose your term). Originally this only pertained to a few Member States, all of them wealthy countries from the EU-15. The EU enlargements in 2004 and 2007 complicated the situation and raised the stakes by making the creation of a wealthy core and lower income periphery within the European Union a stronger possibility. Given that EMU membership is not automatic but a country must qualify for it, the

Eurozone threatened to embody this core–periphery within the European Union, with the Eurozone countries on the inside and the newer Member States on the outside.

In addition to the central and eastern countries (CEECs), other EU countries (Britain, Denmark and Sweden) have also remained outside of the Eurozone but do not appear to have suffered either economically or politically. This presents a challenge to the economic and political rationale for monetary integration. It is significant not only for monetary cooperation but for European integration more generally, as the actual costs and benefits of membership can be examined given the alternative models provided by the European Union – without EMU membership.

4. How does monetary union contribute to the international prestige of the European Union?

In other words, did the introduction of the euro sound the death knell for the dollar? As the world's international reserve currency since the end of the Second World War, the dollar and the US government have enjoyed extraordinary (or, in the words of former French President Charles de Gaulle, exorbitant) privileges. Some analysts have gone so far as to argue that the benefits of a single currency extend beyond economics and the realm of 'soft power', and view a currency as an instrument of hard power. The stakes are quite high, and the weakness of the dollar vis-à-vis the euro in recent years, coupled with the corresponding weakness of the US economy in the wake of rising energy prices, make the dethroning of the dollar a stronger possibility than ever before. What exactly are the benefits associated with issuing the international reserve currency, and what are the costs? The latter are considered less frequently than the former, but are particularly important for the Eurozone given that it is not a nation state like the United States and therefore may not be able to distribute any negative effects across the constituent states. Understanding the Eurozone's and ECB's policies regarding the internationalization of the euro requires a more nuanced understanding than directly comparing the European Union with the United States.

5. What is the impact of monetary integration on European integration?

The *raison d'être* of European integration continues to occupy the thoughts of policymakers, academics and citizens. Given the ambigu-

ous economic benefits of monetary integration, the real justification for monetary union lies in the political realm. Indeed, the spillover effects of policies have been studied since the beginning of integration, and monetary integration can be viewed as both a consequence of spillover (stemming from the internal market project) and the source of spillover (prompting cooperation in employment policy and the subsequent Lisbon Agenda, for example). The issue of spillover in the European Union is complicated by the lack of agreement on the future of the European Union. The crisis surrounding the European Union after the failed constitutional referenda in 2005 led to a period of reflection that resulted in the little-changed Lisbon Treaty, which was then rejected in the Irish referendum in 2008. The future of the European Union and the role that monetary union can and should play in further integration remain uncertain, given the current climate at both the elite and grassroots levels. The financial crisis that spread to Europe in late 2008 demonstrated that better coordination mechanisms (possibly necessitating more institutions or delegation to existing institutions) are needed to deal with a rapidly transforming international economic environment.

Understanding monetary integration – ideas, interests and institutions

This study of European monetary integration thus goes beyond either an historical retelling of the events of the late 1980s and early 1990s or an analysis of its institutions. It takes a holistic approach to understanding EMU, looking at history, theories, policies, institutions and external euro area relations. Each chapter will conclude with a section dedicated to academic research done by economists and political scientists, divided according to the sub-headings of ideas, interests and institutions.

The role of ideas: the political economy of monetary integration

The role of politics in forming economic and monetary policies is an uneasy one. Most of the earlier work done on monetary integration was done by economists, and during the last few decades, monetary policymaking has deliberately been promoted as a policy space best left to technocratic central bankers who can better manage the economy with long-term interests in mind, rather than

the next electoral cycle. The ECB is one of the most independent central banks in the world and has zealously guarded this independence from political pressure. However, the importance of political factors is evident throughout every step of monetary integration. The initiation of monetary integration in the late 1980s and early 1990s was at the behest of not central bankers, but rather political actors. Indeed, political concerns played a more important role than adherence to specific economic ideas, a point repeated by academic economists and central bankers alike.

Ideas-based theories include both economic as well as political ideas. The economic ideas most relevant to EMU are those concerning the advantages of a fixed exchange rate system, optimum currency area theory, the benefits of central bank independence and the need for fiscal and economic policy coordination. A survey of the economics literature on these topics highlights both accepted conventional wisdom as well as some of the disagreements that may exist within the economics profession. Economic logic or necessity is often used to justify policies, but when the economics are indeterminate, the political influences and manipulation of ideas become more apparent.

This is not to say that the use of economic ideas is purely instrumental, as genuine beliefs may have formed and policy learning may have taken place. Indeed some of the policymaking procedures (in particular the open method of coordination) were specifically designed to promote such learning. Therefore the ideas-based theories coming from the political science literature will largely be drawn from those using constructivist theories which argue that policy preferences are not exogenously determined by material interests, but that such interests are formed endogenously.

A related strand of theorizing, referring to the legitimacy of monetary integration and European integration more generally, is also incorporated in this section, as the legitimacy of European monetary integration is closely tied to conceptions of the *raison d'être* of European integration more generally. For those that imagine the European Union as a regulatory state that should minimally infringe on the policies of the Member States, the loose coordination of economic and fiscal policy may be preferable. On the other hand, for those that view monetary integration as a stepping-stone towards greater political integration, such governance structures could be frustrating. Such different conceptions of monetary integration could be tied to larger issues of legitimacy, or they could be linked to interest-based explanations.

Competing interests in monetary cooperation: conflict and compromise

Interest-based theories argue that actors pursue power and material interests. This can refer to the interests of governments (at different levels) as well as the interests of other actors (like financial interests). For example, intergovernmental theories argue that the larger Member States tend to be more influential in decision making than smaller countries; therefore EU policies tend to reflect their preferences. The interests of the Member States are derived from domestic commercial and financial interests as well as domestic actors and institutions. Thus the interests at stake are not only those of the EU Member State governments (and EU institutions) but also domestic actors and institutions.

Explaining the motivation of government policies and whose interests are served is important in understanding monetary cooperation, especially when the economic benefits are either indeterminate or accrue primarily to a select group. Governments face policy choices, and which policy is chosen may not make sense from a purely economic perspective. The economic interests of a country may be ambiguous, and even when the social welfare may improve as a result of following a certain policy, in the short to medium term, there are winners and losers involved. In the most pernicious case, a policy might be detrimental to the economy as a whole but will be adopted anyway due to the inordinate influence of specific actors, such as those with an interest in international trade and finance. The Eurozone, its institutions and policies reflect the interests of the aforementioned actors and their strategic interactions with one another. Moreover because these interests are not static, neither are the policies (and even institutions) of EMU: they constantly evolve as these different interests vie to promote their objectives.

Economic governance and the institutionalization of monetary union

Such diverging policy preferences necessitated the rather complicated governance structure of monetary union. Political scientists have long recognized that ‘institutions matter’ in structuring preferences as well as determining outcomes. At the European level, institutions like the ECB and the Commission have a set of preferences that influence the type of policies that they pursue, which are

distinct from and at times at odds with those of the Member States. The official procedures for policymaking become important, as more ambiguous structures leave room for conflict and necessitate a negotiated solution that is politically acceptable. Similarly institutions within Member States (like national central banks, finance ministries and electoral cycles) influence the preferences of Member States and make some political outcomes more likely than others.

EMU divides power primarily between Community institutions and Member States, most importantly the ECB and the Economic and Financial Affairs (Ecofin) Council. While monetary policy is handled by the ECB, fiscal and economic policy coordination is done through the Ecofin Council and allows Member States to decide on the specific policies they will follow to achieve agreed-upon objectives. Thus EMU governance has strong centralizing tendencies as well as decentralizing ones. Although the ECB and national governments play the most important roles, other institutions such as the Commission and the European Parliament also are involved in the governance of the Eurozone. In addition, the Eurogroup (the subset of Ecofin comprised of Eurozone members) lacked formal status until the Lisbon Treaty but nevertheless became an important forum for the sharing of ideas and building of consensus.

This division of labour is one born of both political compromises as well as path dependence. Indeed, political rather than economic logic dictated the delegation of some policies and the retention by the Member States of other policies. The result is that both the economic outcomes and the political rationalizations have been sub-optimal, as economic and political rationales do not always predict the same policy. For example, according to some economists the delegation of monetary policy to a Eurozone-level body should have been accompanied by the delegation of fiscal policy. However, Member States were loath to give up their right to tax and spend. The compromise was the Stability and Growth Pact (SGP), in which deficit targets were set at the EU level but it was up to the Member States to decide on the specific policy mix that would achieve these targets.

This seemed like a reasonable compromise. Nevertheless it proved difficult for governments to restrain spending during economically difficult times, and respecting European rules like the SGP did not provide a strong enough reason to prevent numerous countries from

breaking the SGP deficit limits. Thus the SGP is an example of political compromise that led to frustrating economic and political outcomes. The Eurozone is distinctive in that its governance structure has multiple sources of authority, making policy disagreements and the pursuit of incompatible objectives more likely.

With the introduction of the euro, new actors like the ECB and the Eurogroup became important stakeholders in the governance of monetary union, alongside the Commission and Member States. These institutions are struggling to build their own constituency and to define their role in the governance process while existing institutions try to maintain or expand their respective influence. At times this brings institutions and governments into conflict with one another. Furthermore the relatively wide array of relevant actors makes it difficult for the Eurozone to speak with a single voice and thus have as much influence in international financial circles as its economic strength would suggest.

Conflicting ideas, different preferences, contradictory incentives and a complex governance structure make political analysis essential to understanding the formation and operation of EMU. Monetary union has achieved much in the first decade, surprising critics but perhaps disappointing its more ardent supporters. How the Eurozone fares in the coming decade in promoting economic objectives (price stability, employment, growth), political objectives (greater political integration, extension of EU competences into issue areas like employment and social policy), and external objectives (challenging the dollar as the international reserve currency, reducing the vulnerability of the euro and European financial markets to market speculation) will depend on a myriad of factors, making monetary integration one of the most interesting and important EU policies for those interested in political economy and financial issues.

Plan of the book

Of course these three analytic constructs of ideas, interests and institutions are not completely distinct from one another, and overlap exists. Nevertheless such categories provide a useful starting point of analysis and make it possible to provide some structure to the growing literature on economic and monetary policy. This book will provide an empirical and theoretical account of economic and monetary integration. Each chapter begins with a description of the major historical events and a description of the institutional configuration,

when appropriate, followed by a summary of the theoretical analyses. The theoretical section is generally divided into theories based on ideas, interests and institutions, with some deviations from this structure depending on the specific chapter. Of course this book cannot give an exhaustive account of all of the theories used, but a broad overview is given of economic and political theories of monetary and economic cooperation.

Chapter 2 provides a history of monetary integration from the Bretton Woods system up until the hard phase of the European Monetary System (EMS). The history of monetary cooperation continues in Chapter 3, which covers the Maastricht Treaty negotiations up until the present day. International influences are considered in addition to those found at the European and domestic levels, given the importance of the US dollar in the international monetary system. Taking a long-term view of economic and monetary cooperation in Europe allows one to see the changing ideas and subsequent institutionalization of such ideas in policies like exchange rate cooperation and central bank independence. The inordinate influence of France and Germany in shaping monetary integration is also readily apparent, as cooperation in this area serves important economic and political interests in these countries. These interests and ideas led to the current governance structure that continues to impact monetary and economic policymaking in the European Union.

Chapters 4 and 5 introduce the decision-making structure of EMU, and cover the functions of the major institutions of EMU as well as their relationship with one another. The institutions included in this study are the ECB, the Eurogroup, the Ecofin Council, the Economic and Financial Committee (EFC, formerly the Monetary Committee), the Commission and the European Parliament. The reasons for the rather complicated division of labour, the functions each institution serves, and how well the governance system has worked thus far are considered. Chapter 5 provides a more in-depth analysis of the history, structure and policies of the ECB. This chapter explains the primary duties of the ECB as an institution and how well it has fared in achieving the objectives set by the European Union. However, before it even came into operation the ECB was criticized for being too independent, lacking adequate mechanisms of accountability with other institutions that could provide legitimacy. Theories on central bank independence are therefore discussed, considering both its merits and its limitations.

Chapter 6 looks at fiscal and economic policy coordination in EMU. It first considers the political impetus behind the creation of the SGP and the economic rationalizations that were later used to justify it. Indeed, the utility of the SGP in both its original and current form was hotly debated among economists, and ultimately its course followed a political logic, as large Member States like France and Germany ignored the policy prescriptions associated with the pact until the Ecofin Council altered the pact to suit the policy imperatives of Member States in March 2005. The story of the reform of the SGP incorporates elements of intergovernmentalism (large states not being punished for transgressions), domestic politics (in particular the French government's willingness to violate the pact in the interest of pursuing further growth), institutionalism (the difficulties of the relationship between the ECB and the Eurogroup given their at times unclear mandates) and the dissemination of ideas (regarding the relationship between technocratic and political bodies and economic ideas on the efficacy of fiscal policy coordination).

In addition to the coordination of fiscal policy under the SGP, the economic arm of the EMU relies on the coordination of economic policy, largely using the open method of coordination. Monetary policy cannot be effective in isolation from other economic policies, as actions in one area can run counter to other economic policies. The Broad Economic Policy Guidelines (BEPG), European Employment Strategy (EES) and the Lisbon Agenda have all employed the open method of coordination (OMC), which has alternately been described as a first step towards further integration and as a new method that essentially amounts to a talk shop with little chance of influencing actual policy. The open method operates as a system of benchmarking whereby Member States learn from one another's best practices through a system of peer review, and a section is devoted to both the praise and criticism that the open method has elicited.

Chapter 7 considers the countries outside of the Eurozone. The three EU15 countries of the United Kingdom, Denmark and Sweden are considered as well as the countries that acceded to the EU in 2004 and 2007. The economic and political rationale for each EU15 country's decision to remain outside of EMU are analysed, as well as how this decision has affected these countries economically and politically in terms of their relationship with EU insiders. In the case of the 2004 and 2007 accession countries, each

one's prospects for future membership is considered, along with how their inclusion could affect the functioning of the Eurozone. The chapter concludes with a reflection on the impact a multi-speed EMU has had on European integration more generally. Theories explaining these developments, including those based on power politics (in particular a country's ability to remain influential while outside the Eurozone), institutions (the stickiness of the Maastricht Treaty despite the arguably inappropriate application of its convergence criteria to the new Member States), and constructivism (the prevalence of more neoliberal ideas in the new Member States and how that affects their relationship with current Eurozone members) are also covered.

Chapter 8 focuses on the international role of the euro, how a single currency has affected the European Union as an economic entity, and the impact that it has made internationally. In particular, the ability of the euro to challenge the dollar's hegemony has been the topic of much discussion. What it takes to be a key currency, why the dollar has been able to hold the top position for decades despite the macroeconomic challenges it has faced (such as its twin deficits) and the impact the Eurozone could have on international financial management, comprise much of this chapter. In addition, although the Eurozone as an international financial actor is still a work-in-progress, the internal difficulties it faces in speaking with a single voice pose a substantial obstacle to its ability to fulfil its potential in this regard, and the reasons behind this are taken into account. Some recent public disagreements between various actors in the Eurozone (such as the ECB and Ecofin members) are recounted in order to illustrate the continued weakness of the Eurozone in acting as a coherent political body.

Chapter 9 gives an initial balance sheet of EMU after its first few years of operation. Its economic and political triumphs and difficulties are considered. The extent to which it has functioned as originally planned, how it has conformed to or defied predictions, and its ability to produce economic and political benefits for the European Union as an organization and its respective member states are considered. After a decade since its launch, an appraisal of how the Eurozone is functioning thus far is in order, along with a consideration of how problems are being handled by the European Union.

Chapter 10 revisits the themes presented in Chapter 1. The backdrop to monetary integration has always been political calculations,

which include the contribution it makes to European integration and the extent to which it empowers the European Union and its Member States. The politicization of monetary integration is emphasized, pointing out instances in which institutional solutions were derived as the result of political (as opposed to economic) imperatives, and how theories from political science and international political economy have increased our understanding of European integration and monetary integration as a case study of this. The tension between international, European and domestic imperatives is reconsidered, and so are the future prospects of the euro in terms of promoting (or perhaps hindering) further integration and its impact on the international system.

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