What Forces Propelled European Countries Towards Currency Union?

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Contents of the presentation

- A brief timeline of monetary integration
- The global context
  - US monetary influence and globalisation
  - The fall of the Communist bloc and German unification
- Neofunctionalist explanations: the ‘spillover effect’ of the Single Market
  - ‘Economic efficiency’ version
  - ‘Political economy’ version
- Ideational factors
  - Monetarism
  - European identity
- Intergovernmentalist explanations
  - the Franco-German bargain
  - Additional leverage: cross-issue linkages and two-level games

Timeline of Monetary Integration

1970 – the Werner Report sets out a plan for a three-step transition to monetary union. It is quickly shelved as the Bretton Woods System collapses.

1972-1979 – 'Snake in the Tunnel': more modest ambition of limiting exchange rate volatility within 2.25% fluctuation bands from the Deutschmark. UK, Ireland, France and Italy leave. By 1975 it applies only to the Benelux franc, the Dutch guilder and the Danish krone.

1979 – EMS is established. It includes two elements: a basket of currencies (ECU), weighted according to the strength of participating currencies, and an exchange rate mechanism (ERM), consisting of a central ECU with 2.25 bands of fluctuation. After a rocky start, its performance improves. Spain, Portugal and the UK join in the late 1980s/early 1990s.

1988-9 – Delors committee sets out a three-stage plan for currency union (EMU)

1992-1993 the EMS collapses under speculative pressure. UK and Italy leave the ERM. The bands of fluctuation are widened to 15%.

Timeline of Monetary Integration

1992-3 – The Maastricht Treaty sets out the convergence criteria for EMU membership: inflation below 1.5, interest rates not above 2% from the three best performers, deficit below 3%, debt below 60% of GDP, membership of the ERM without devaluations for two years. It also sets out the institutional structure of the EMU: an independent central bank with the central goal of price stability, with some supervisory power for ECOFIN.

1997 – the SGP sets out the budgetary rules to follow after the introduction of the Euro.

1998 – the ECB is created. All the 11 applying countries are accepted as members of the EMU (with some fudging of the convergence criteria).

1999 – the Euro is introduced. Notes and coins start circulating in 2002.

2000-2015 – other 8 countries join the Euro. Denmark and Sweden reject the Euro in two referendums (2000 and 2003).

Global context (1): Countering the dollar hegemony

Monetary integration to limit unilateral US monetary influence.

Particularly after the US suspends the dollar's convertibility into gold, American monetary policy has recurrent destabilising effects on European economies, which are matched by a push for further monetary integration (Henning, 1998).

- "*Germany's number one objective [was] to unwind the dependence on the dollar […] The German idea of creating a zone of monetary stability independent of the dollar—even though unprofessional—was an economic expression of this political attitude*." (Erik Hoffmeyer, Governor of the Bank of Denmark)

Need for currency union more urgent with globalisation and the rise of Japan:

- European currencies' exposure to trade shocks and two monetary superpowers
- Increased trade flows lower the opportunity costs of giving up monetary autonomy. (Sandholtz and Zysman, 1992; Verdun, 2000)

U.S. disturbance	*Causal link*	*European response*
1958–61: U.S. overall balance of payments shifts from surplus to deficit	Capital flows to Europe, causing a revaluation of the deutsche mark in 1961	Hallstein initiative; Committee of Central Bank Governors created
1967–71: U.S. expands; adopts "benign neglect"	Transmission of inflation to Europe; chronic international monetary crises; instability in European cross rates	Werner Report of 1970 proposes EMU
U.S. suspends gold convertibility in 1971 and switches to flexible exchange rates in 1973	Currency instability threatens the Common Market	Creation of the snake
Locomotive conflict of 1977–78; U.S. presses German government to reflate	Dollar depreciation drives wedges between European currencies	Creation of the EMS
Reagan policy mix drives U.S. interest rates upward	Dollar appreciation aggravates European inflation and supports growth	France chooses to remain in the ERM in March 1983
Reflation controversy of 1985–87	Dollar depreciation places pressure on the EMS	Basle–Nyborg agreement and creation of Delors Committee
Late 1980s and early 1990s: continued fiscal deficits, renewed neglect, and pressure for policy adjustment	Dollar weakness contributes to weakness of European periphery relative to core	Maastricht Treaty negotiated, ratified, and pursued

Global context (2): the fall of the Communist bloc and German reunification

The reunification of Germany changes the balance of power in Europe (Grieco, 1996)

Renewed interest to bind Germany into deep co-operative frameworks. Germany is more willing to give up the Deutschmark in exchange for international legitimacy of its unification.

"*Mitterrand did not want reunification without advances toward greater European integration, and the currency was the only topic that was open to debate*." (Védrine, advisor to Mitterand)

However, Delors Report was published in April 1989, so German reunification at best *accelerated* a process already in motion.

"*Monetary union would have taken place even without reunification*" (Bitterlich, advisor to Kohl)

Rebuttal: even before 1989, France was fearful that Germany's economic and geostrategic mires would 'turn East' following Gorbachev's reforms and opening to the West.

Neofunctionalist explanations (1): 'economic efficiency' version

Trade integration through the SEA created technical spillovers for monetary union:

- Reducing costs of currency exchange
- Reducing exchange rate uncertainty
- Preventing competitive devaluations and speculative attacks (1992/3 exchange rate crisis in Italy and UK)

"*The principal benefit of fixed rates and a single currency was to facilitate intra-European trade and investment*" (Frieden, 2002)

Frieden finds that greater integration is associated with higher commitment to exchange rate stability.

Central role of EU actors (Delors Commission) in spurring the integration process.

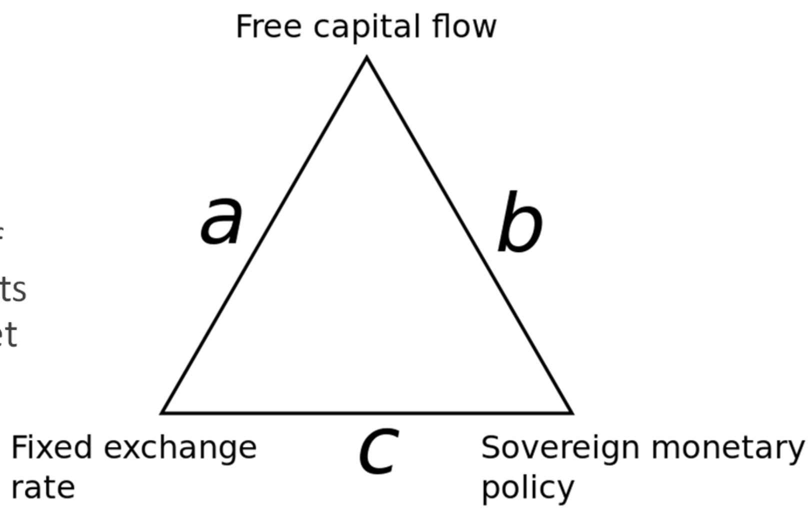
BUT efficiency gains from currency union are small compared to the breadth of the euro-zone as it was ultimately established.

Neofunctionalist explanations (2): ‘political economy’ version

EMU is necessary to ensure political support for the Single Market in the long term from key constituencies

Floating exchange rates have distributional effects:

- Cross-border inverstors and exporters producers stand to gain more from a fixed exchange rate and low volatility
- for import competers, the exchange rate is, *in theory*, inconsequential but in practice it means (a) bearing the brunt of austerity to get in line with the Deutschmark, and (b) higher costs if another country ‘cheats’ by depreciating and floods the market with cheap exports (1992/3 devaluation)



The more integrated EU economies become, the more pronounced the distributional effects of currency swings.

Import-competing producers need stronger guarantees against other countries’ opportunistic exchange rate policies.

Ideational factors (1): Monetarism

Why weren't EC/EU countries more concerned about giving up monetary autonomy?

Interest definition as historically dependent on policy-makers' shared beliefs.

A paradigm shift in economic thinking away from Keynesianism: Monetarism posits that monetary tools are unable, in the long term, to bring unemployment under control, and the main function of monetary policy is to control inflation.

Reframed in these terms, monetary sovereignty is not so valuable, and price stability can be best achieved by delegating control to a 'credible' central bank pursuing 'sound money' policies.

McNamara (1998):

- Policy failure (stagflation of the 1970s)
- Policy paradigm innovation (new conception of the government as a macroeconomic actor)
- Policy emulation (Germany's successful pragmatic version monetarism)

Ideational factors (1): Monetarism

Diffusion of monetarist thinking and impact of these ideas on decision-making through 'epistemic communities': the political, technocratic and financial elites (Verdun, 1999)

Transnational as well as supranational agency:

"Transnational actors and their politics were present and influential throughout the development of the EMU initiative, from the first meeting of the Delors Committee in 1988 to the last meetings of the IGC nearly four years laters, and in some respects […] they more influential than either governmental or supranational actors" (Cameron, 1995)

The Delors Committee (1988) as an epistemic community (Verdun, 1999)

Ideational factors (2): European identity

Perception of interests is influenced by policy-makers' visions of European political order and elite commitment to the European ideal. Crucial to explain Kohl's enthusiasm for the EMU.

Euro as an identity-creating tool (Kaelberer, 2004)

German post-World War II identity: overcome nationalist past (Risse, 2003)

- "If the Euro-currency is not realized by January 1, 1999, it will most likely never again be realized; This would result in the worst crisis of the European integration process — possibly its end!" (Kohl)

Reconstruction of French identity: continental *mission civilisatrice* following failure of dirigiste 'exceptionalism' (Risse, 2003)

- "We are at the moment where everybody unites, our fatherland, our Europe, Europe our fatherland, the ambition to support one by the other, the excitement of our land and of the people it produces, and the certainty of a new dimension is expecting them" (Mitterand)

European periphery: positive evaluation of 'being/becoming European' (Luna-Arocas et al, 2001)

Intergovernmentalist explanations: The Franco-German Deal

Although all the above factors were in the background, ultimately it is national governments that negotiated away sovereignty *with their national interest in mind* (Moravcsik, 1999)

Very ‘realist’ gist to the argument: EMU outcomes reflect the interests of the largest and most powerful states: France and Germany.

France’s objectives:

- Regain control of monetary policy (and possibly soften German ‘sound money’): EMU would give France equal representation, while in the EMS all decisions are taken by the Bundesbank (de Grauwe, 2013)
- Avoiding German hegemony outside tight bounds of a EU-level framework

Germany’s objectives:

- Preserving currency stability
- Foreign policy crisis linked to unification

Intergovernmentalist explanations: The Franco-German Deal

The EMU was more clearly a French strategic priority. Germany's position was stronger, as it had less to lose from withdrawing from the negotiations. The outcome thus reflects the achievement of many German preferences on the structure of the new monetary arrangement:

- Convergence criteria
- ECB independence
- Price stability as the ECB's main goal
- Stability and growth pact

However, France extracted:

- National bank governors influence on the ECB Executive Board
- Political oversight role of ECOFIN
- Politicisation of the choice of the ECB President

Particularistic motivations

Cross-issue linkages (Martin, 1993)

Intergovernmental bargaining takes place within a structured institutional settings, where a policy in one area can be advanced through concessions in other areas:

- Doubling of structural funds to Spain, Greece, Ireland and Portugal
- Elements of Political Union desired by France, Italy and others enshrined in Maastricht

Two-level games

'Cutting slack' strategy: using international agreement to pursue domestic goals

- In France (1983) and Italy (1992), monetary integration was used to reduce the political costs of disinflationary policies (*vincolo esterno*)

But also the other way around: Kohl pushed through the EMU, despite the lack of a domestic consensus, by linking it to the goal of German re-unification.

Conclusions: what forces propelled European countries towards currency union?

- EC countries faced a set of global economic and strategic challenges.
- These challenges were addressed within the framework of existing EU-level institutions.
- However, it is doubtful that currency union was simply a corollary of the Single Market.
- Monetarist thinking of the time and ideological enthusiasm for the European project may have contributed to reduce worries about the currency union's economic sustainability.
- But ultimately, political calculations dominated decision-making.
- In particular, the establishment of the EMU was strongly influenced by the conjunctural alignment of French and German interests.