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Economic and Monetary Union

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Reader's Guide

This chapter provides an introduction to economic and monetary union (EMU). It describes the key components of EMU and what happens when countries join. EMU was the result of decades of collaboration and learning, which have been subdivided here into three periods: 1969–91, taking us from the European Council's first agreement to set up EMU to Maastricht, when the European Council included EMU in the Treaty on European Union (TEU); 1992–2002, from when plans for EMU were being developed to the irrevocable fixing of exchange rates; and 2002 onwards, once EMU had been established, and euro banknotes and coins were circulating in member states. Next, the chapter reviews various theoretical explanations, both economic and political, accounting for why EMU was created and looks at some criticisms of EMU. Finally, the chapter discusses how EMU has fared under the global financial crisis and the sovereign debt crisis, and at what we may expect of it in the years to come.

Introduction

Euro banknotes and coins were introduced on 1 January 2002. On that date, the euro became legal tender in 12 EU member states, among a total of more than 300 million people. All member states of the European Union, except Denmark, Sweden, and the UK, participated. It signalled the start of a new era in the history of the EU not least because, from this point on, the majority of EU citizens were, on a daily basis, in contact with a concrete symbol of **European integration**. What was the path that led to the euro?

Economic and monetary union (EMU) has been an integral part of European **integration** since the early 1970s, although those early plans were derailed. Once back on track in the late 1980s and 1990s, supporters of the idea of **monetary union** wanted to make sure that the process was done properly. Member states agreed that there should be economic and monetary convergence prior to starting EMU. But at the same time, some member states (such as the UK) did not want to join EMU.

What is economic and monetary policy?

Having a common currency is not unique to the European Union; the Roman Empire had a single currency. Belgium, France, Italy, Switzerland, and others were part of a Latin monetary union (LMU) from 1865 to 1927. They minted francs that were of equal value across their union. In 1872, the Danes, Norwegians, and Swedes launched a single currency, the Scandinavian krona, used until the outbreak of the First World War in 1914. Although the 19th-century European monetary unions were significant, the scale and scope of economic and monetary union in the EU is further reaching, because these earlier unions only **harmonized** coinage and did not introduce a **single monetary policy** or a **central bank**. Thus EMU is without doubt the most spectacular and ambitious monetary union of all time.

The component parts of EMU

EMU, as we know it in the EU, refers to the union of participating countries which have agreed to a single monetary policy, a single monetary authority, a single currency, and coordinated macroeconomic policies. Let us clarify these features.

First, what is monetary policy? Central banks formulate and implement monetary policy, in some cases in collaboration with the government—that is, with the ministry of finance and sometimes also with the economics ministry. Monetary policy aims at influencing the **money supply** and **credit conditions**. Central banks set a key **interest rate**. In EMU, monetary policy is no longer formulated at the national level, but decided upon at the European level by a single monetary authority: the **European Central Bank (ECB)**.

In December 1991, the Maastricht European Council agreed to create a European System of Central Banks (ESCB). This consists of the ECB and the already existing national central banks, which, in EMU, are just 'branches' of the new ECB. The ECB Governing Council is responsible for formulation of the monetary policy for the '**eurozone**' or '**euro area**'. The ECB is responsible for the new single currency, sets a key short-term interest rate, and monitors the money supply. To facilitate coordination of economic and financial policies, an informal ministerial group has been set up: the so-called '**Eurogroup**'. It consists of the ministers of finance, and sometimes economics, who get together to coordinate policies. The group typically convenes before the meeting of the EU Council on Economic and Financial Affairs (ECOFIN).

Strictly speaking, EMU could still have been possible without the introduction of a single currency. There were two alternatives: participating countries could have kept their national currencies and fixed their exchange rates irrevocably; or they could have introduced a common currency in parallel to the existing national currencies—something that the British government suggested in 1990 (the 'hard **European currency unit (ecu)**' proposal), but which did not receive support. While a parallel currency is introduced *alongside* existing national currencies, a single currency *replaces* them. A single currency would reduce the transactions costs that banks charge when currencies are exchanged. It was also politically more attractive because it would signal a full commitment to EMU.

Finally, in order to have a successful mix between fiscal and monetary policies, EMU envisages the coordination of economic policies (Article 121 TFEU). To secure the euro as a low-inflation currency, there are rules on **public debts** and **budgetary deficits**

Article 126 TFEU states that member states must avoid budget deficits in excess of a **reference value**—set in a protocol annexed to the Treaty at three per cent of **gross domestic product (GDP)**—and general government debt should be at or below a reference value (60 per cent of GDP). Furthermore, monetary financing of the debts and deficits would not be permitted: countries could no longer use the printing press to create money to service their debt. This so-called 'no bailout clause' was put in place to reduce the likelihood of the ECB having to bail out member states should they be unable to pay their debts (Article 125 TFEU). Prior to EMU, a member state that ran high budget deficits with inflationary consequences would have been 'punished' by the market, because it would have needed to set higher short-term interest rates as a consequence.

The acronym 'EMU' consists of two components, 'economic' and 'monetary', with the latter the most prominent component. The term '*economic and* monetary union' can be traced back to the discussions in the late 1960s and early 1970s. The policy-makers at the time were not sure how best to create EMU. To have fixed exchange rates—and ultimately a single currency—required some coordination of economic policies. Some countries—Belgium, Luxembourg, and France—thought that, by fixing the exchange rate, the necessary **cooperation** of the adjacent economic policies would naturally start to occur (the '**Monetarists**'). Two other countries—West Germany and the Netherlands—held the opposite position. In their view, economic policies needed to be coordinated *before* fixing exchange rates or introducing a single currency (the '**Economists**'). This debate is referred to as the dispute between the 'Monetarists and the Economists'. (Note that the term 'Monetarists' used in this context does not have the same meaning as the term 'monetarists' referring to the followers of the ideas of Milton Friedman.)

The question of how to reach EMU had already been discussed in some detail by economic thinkers of the 1960s such as Bela Balassa and Jan Tinbergen. According to these and others, economic integration can be subdivided into a number of stages (see also Chapter 18). Originally, it was thought that these stages would be consecutive and that they would follow each other at a regular pace. More recently, this sequential order has been called into doubt: there is no clarity as to whether they should follow each other, or what the expected timing would be. Yet even though the framework may not be helpful as a predictive tool, it is still a useful analytical device.

The least far-reaching form of integration is a **free trade area (FTA)**. In an FTA, participating members remove **barriers to trade** among themselves, but maintain the right to levy tariffs on third countries. The next stage of integration is a **customs union**. In addition to the free trade among members, a customs union has **common external tariffs** on goods and services from third countries. A **common market**—since 1985, renamed **single market**—is characterized by free movement of goods, services, labour, and capital among the participating states, and common rules, tariffs, and so on vis-à-vis third countries. An **economic union** implies not only a common or single market, but also a high degree of coordination of the most important areas of economic policy and market **regulation**, as well as monetary policies and income redistribution policies. A 'monetary union' contains a common or single market, but also further integration in the area of currency cooperation. However, deeper integration does not always occur in a monetary union: the Scandinavian monetary union did not contain a customs union. A monetary union either has irrevocably fixed exchange rates and full **convertibility** of currencies, or a common or single currency circulating within the monetary union. It also requires integration of budgetary and monetary policies. An economic and monetary union (EMU) combines the features of the economic union and the monetary union. This combination is what European leaders had in mind when they discussed EMU in 1969 and again in 1988. A **full economic union (FEU)** implies the complete unification of the economies of the participating member states and common policies for most economic matters. A **full political union (FPU)** is the term used when, in addition to the FEU, political governance and policy-making have moved to the **supranational** level. Effectively, political unification occurs when the final stage of integration has taken place and a new **confederation** or federation has been created.

The eventual institutional design of EMU in the 1980s and 1990s was an asymmetrical one (Verdun, 1996, 2000). It featured a relatively well-developed monetary union, but a much less developed economic union. Monetary policy was to be transferred to a new European **supranational institution** (the European Central Bank (ECB)), whereas in the area of economic policy-making decisions remained the full

responsibility of national governments. To some extent, one observes here the difference between positive and **negative integration**. **Positive integration** refers to the creation of common rules, norms, and policies. Negative integration is all about taking away obstacles, and eliminating rules and procedures that are an obstruction to integration.

> **KEY POINTS**
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> - Economic and monetary union consists of a single monetary policy, a single monetary authority, a single currency, a single market (including free movement of capital), and coordinated macroeconomic policies.
> - The 'Monetarists' and the 'Economists' differed in opinion as to how best to create EMU.
> - There are various stages of integration, ranging from a free trade area to a full political union. The stages are an analytical device.
> - EMU can be characterized as asymmetrical.

From The Hague to Maastricht (1969–91)

At the 1969 Hague Summit, the heads of state and government decided to explore a path to economic and monetary union. A group of experts, headed by Pierre Werner, prime minister and finance minister of Luxembourg, drafted the blueprint. The 1970 **Werner Plan** proposed three stages to reach EMU by 1980. On the institutional side, it recommended setting up two supranational bodies: a Community System for the Central Banks and a Centre of Decision for Economic Policy. The former would pursue monetary policies, while the latter would coordinate macroeconomic policies (including some tax policies). Most of the recommendations of the Werner Plan were adopted, but EMU did not take off in subsequent years.

There are two reasons why the creation of EMU stalled in the 1970s. First, there were substantial differences among the member states about how to get to EMU. Second, the international economic and monetary situation rapidly changed in the early 1970s, making for a totally different climate for cooperation. The so-called **Bretton Woods agreement**, which had facilitated stable exchange rates in Western Europe since 1945, ended in August 1971. West European countries responded by setting up their own **exchange rate mechanism (ERM),** the so-called **'snake'**, which functioned with moderate success throughout the 1970s and in which not all member states participated, though several non-EEC members were involved.

Developments leading to the relaunch of EMU in the late 1980s

In 1979, the **European Monetary System (EMS)** was set up, in which all European Community (EC) member states were to participate. Not all were immediately part of its most important feature, the exchange rate mechanism or 'ERM'—a system of fixed, but adjustable, exchange rates. The UK was not part of the ERM during the 1980s, but its currency was part of the European currency unit (ecu)—the unit of account at the heart of the EMS. In 1991, the British pound sterling did join the ERM, but it was forced to leave on 16 September 1992 (**'Black Wednesday'**) following a period of intense selling of sterling in the financial markets, which the British government was unable to bring to a halt. Italy participated in the ERM from the outset, but was initially given more leeway. The rules stipulated that most currencies could not fluctuate more than ± 2.25 per cent from an agreed **parity**, whereas the bandwidth for those who needed more leeway (for example, Italy) was set at ± 6 per cent from the parity. If a currency threatened to move outside the agreed band, central banks would intervene by buying or selling currencies in order to keep the currency from leaving the band. If an imbalance were persistent, the so-called EC Monetary Committee (MC), an informal advisory body created by the **Treaty of Rome** to discuss monetary policy and exchange rate matters, would decide whether or not to adjust the parities. In 1999, the MC was renamed the Economic and Financial Committee (EFC).

The ERM needed some time to become successful. The first four years (1979–83) were learning years, with numerous exchange rates fluctuations and parity adjustments. The participating currencies became more stable in the interim period (1983–87), and thereafter, until summer 1992, the ERM witnessed no realignments. By this time, it had become an important 'symbol' of successful European integration. In the 1980s, the West German currency, the Deutschmark, became the 'anchor currency'. Because it had been a **strong currency**, monetary authorities in ERM countries took German monetary policies as their point of

BOX 21.1 THREE STAGES TO ECONOMIC AND MONETARY UNION

First stage	1 July 1990–31 December 1993	Free movement of capital among member states Closer coordination of economic policies Closer cooperation among central banks
Second stage	1 January 1994–31 December 1998	Convergence of the economic and monetary policies of the member states (to ensure stability of prices and sound public finances)
Third stage	1 January 1999–to date	Establishment of the European Central Bank Fixing of exchange rates Introduction of the single currency

reference, following the decisions of the German central bank (the *Bundesbank*) quite closely.

A few other developments in the 1980s helped to revive the EMU process. The 1986 **Single European Act (SEA)** facilitated the completion of the single market and mentioned the need to relaunch EMU. The 1988 Hanover European Council mandated Commission President Jacques Delors to head a committee composed of the 12 central bank presidents, another Commissioner, and a few experts to draft a blueprint for EMU. Just as the earlier **Werner Report**, the **Delors Report** (April 1989) proposed a road to EMU in three stages (see Box 21.1). It also envisaged the creation of a European System of Central Banks (ESCB). In contrast to the Werner Report, it did not find it necessary to set up a similar supranational institution in the economic sphere, but it had the same objectives: full freedom of goods, services, capital, and labour, and, if possible and if the political will was there, the introduction of a single currency. On the basis of the Delors Report, the June 1989 Madrid European Council adopted the EMU blueprint, with the first stage of EMU (the **liberalization of capital markets**) starting on 1 July 1990. An **intergovernmental conference (IGC)** opened in Rome in October 1990 and closed in Maastricht in 1991 to discuss the next stages (see Chapter 2). One of the decisions taken during the IGC negotiations was that countries would have to meet certain criteria, dubbed '**convergence criteria**', in order to be allowed to join EMU.

The Maastricht convergence criteria (see Box 21.2) referred to good performance in the area of inflation rates, interest rates, and exchange rates. Moreover, it was agreed that participating countries should not have excessive budgetary deficits or public debts. Finally, the national central bank needed to be made politically independent, and national monetary authorities could no longer use the printing press to reduce public debts and budgetary deficits (monetary financing). It is important to note that, right from the outset, there were 'escape clauses' built into the wording of the **Maastricht Treaty**. It was generally thought that the criteria would be applied generously with regard to the debt criterion, because it was believed that some countries, such as Belgium and Italy, would never be able to meet the reference value in less than a decade. As for the budgetary criteria, however, these *had* to be met.

It has been speculated that the creation of EMU was assisted by the fall of the Berlin Wall in 1989, and the end of communist **regimes** in Central and Eastern

BOX 21.2 THE MAASTRICHT CONVERGENCE CRITERIA

- Budget deficits should be no more than three per cent of gross domestic product (GDP).
- Accumulated public debt should be no more than 60 per cent of GDP.
- Exchange rates should have participated without devaluation or severe tensions in the exchange rate mechanism (ERM-2) for at least the previous two years.
- Inflation should not be more than one and a half percentage points above the rate of the three best-performing member states.
- Long-term interest rates should be not more than two percentage points above the rate of the three best-performing member states.

Source: Article 140 TFEU and Protocol 12.

Europe (CEE) in 1990. The observant reader will have noted, however, that the Delors Report had already been completed by April 1989 and therefore preceded these turbulent political developments. Nevertheless, the political determination of German Chancellor Helmut Kohl to secure EMU was connected to his eagerness to move ahead quickly with German unification. The IGCs were completed in December 1991, and the European Council in Maastricht agreed to revise the Treaty of Rome and accept a new Treaty on European Union (TEU). It was signed on 7 February 1992 and came into force on 1 November 1993, after the national parliaments of all 12 member states ratified it.

KEY POINTS

- In the 1970s, EMU stalled because of differences among member states and changing international circumstances.
- The European Monetary System and the Single European Act contributed to the relaunch of EMU in the late 1980s.
- The Delors Report offered a blueprint for EMU.
- The treaty changes necessary for acceptance and implementation of EMU were negotiated in an intergovernmental conference, which was completed in Maastricht in 1991. Member states need to meet the 'Maastricht convergence criteria' to join EMU.

From treaty to reality (1992–2002)

The period from 1992 to 2002 posed numerous challenges for economic and monetary union, most notably over the **ratification** of the Maastricht Treaty, the issue of what would happen post-EMU, and the 'real' criteria for membership of the monetary union.

Ratification problems and the 'real' convergence criteria

The ratification process of the Maastricht Treaty turned out to be challenging. Only months after the Treaty was signed, on 2 June 1992, Danish citizens voted against it in a referendum. A razor-thin majority rejected the Treaty (50.7 per cent against; 49.3 per cent in favour). A French referendum was held on 20 September 1992. Against the background of major speculation in the financial markets, which had resulted in the British pound sterling and the Italian lira leaving the Exchange Rate Mechanism (ERM) days before the referendum, the French referendum resulted in a very slim majority in favour of the Treaty (51.05 per cent in favour; 48.95 per cent against). The result surprised most observers, because the French had been supporters of European integration. The period from late 1992 through to early 1994 was characterized as one of continued exchange rate turbulence, placing the ERM under further pressure and casting a shadow on the run-up to EMU. In August 1993, the ERM exchange rate bands were widened from ± 2.25 per cent to ± 15 per cent. After the introduction of the euro, a new system, the ERM II, was set up to succeed the previous ERM. It officially maintained the ± 15 per cent bands.

In May 1998, the European Council decided that 11 countries would participate in EMU from 1 January 1999—the day on which exchange rates would be irrevocably fixed between the participating member states. However, Denmark, Sweden, and the UK did not want to join, whereas Greece was judged ready in June 2000 and joined the euro area as the 12th member on 1 January 2001.

When eight Central and Eastern European (CEE) countries and two very small Mediterranean countries joined the EU on 1 May 2004, the **accession treaty** stipulated that these countries would eventually join EMU. However, they had to wait at least two years and fulfil the convergence criteria before they could adopt the euro. In 2007, Slovenia became the first new member state to join EMU. In 2008, Cyprus and Malta joined; in 2009, Slovakia became the sixteenth member of the euro area. The Baltic States have been the most recent to join: Estonia in 2011, Latvia in 2014, and in 2015, Lithuania became the 19th member of the euro area.

Managing EMU: the Stability and Growth Pact (SGP) before the sovereign debt crisis

In the mid-1990s, the then German Finance Minister, Theo Waigel, proposed rules for countries once in EMU. The **Stability and Growth Pact (SGP)** was put in place to ensure that no single member state, once it had become a member of EMU, could **freeride**, for example, by incurring high debts and deficits. Under the SGP, member states that violate the rules to keep their public debt and budgetary deficit low can be penalized, and may have to pay a fine. The SGP was designed primarily to work as a deterrent.

The SGP involves **multilateral budgetary surveillance** (a 'preventive arm'), as well as specifying a

BOX 21.3 THE STABILITY AND GROWTH PACT

The Stability and Growth Pact aims to ensure that member states continue their budgetary discipline efforts after the introduction of the euro.

Dates	Decisions
The SGP comprised a European Council Resolution (adopted at Amsterdam on 17 June 1997) and Regulations of 7 July 1997 The Council Regulations were revised on 27 June 2005 The rules were further strengthened in 2010 and 2011 ('**six pack**'), in 2012 (the **Treaty on Stability, Coordination and Governance**) and in 2013 ('**two pack**')	The surveillance of budgetary positions and coordination of economic policies Implementation of the excessive deficit procedure (EDP)
Annually since 1999	Member states have undertaken to pursue the objective of a balanced, or nearly balanced, budget, and to present the Council and the Commission with a stability programme Euro-outs (member states not taking part in the third stage of EMU) are also required to submit a convergence programme Opening and closing (where appropriate) of an excessive deficit procedure for EU member states
Since 2010, procedures strengthened, streamlined, and formalized with the **European Semester**	The European Commission analyses the fiscal and structural reform policies of each member state, provides recommendations, and monitors their implementation; the member states implement the commonly agreed policies

deficit limit, the **excessive deficit procedure (EDP)** (a 'corrective arm') (see Box 21.3). When, on the basis of a Commission recommendation, the Council decides that an excessive deficit indeed exists, the member state concerned is obliged to reduce its deficit below the Treaty's reference value of three per cent of GDP; otherwise financial sanctions can be levied against the member state in question.

In 2002, France, Germany, and Portugal were given an 'early warning' that they were in breach of the SGP. Portugal made the necessary corrections so the EDP was abrogated in 2004. But France and Germany failed to make the necessary adjustments to reduce their budgetary deficits. By November 2003, both were heading for the next step in the EDP (Article 126 TFEU) and thus were coming closer to the financial sanctions set out in the SGP. At an ECOFIN meeting on 25 November 2003, a proposal by the Commission to move France and Germany closer to the sanctions was defeated. The result was that the SGP was interrupted for the cases of France and Germany. The crisis atmosphere that resulted from the 25 November 2003 Council decision prompted the European Commission to ask the Court of Justice of the EU (CJEU) whether this Council decision was legal. In July 2004, the CJEU ruled that the November 2003 Council decision was, in fact, *illegal* because the Council had adopted its own text outside the context of the Treaty. But the Court ruled that the Council has the right not to follow the recommendations of the Commission. The result of these developments was that the Commission felt that the SGP needed to be adjusted. By spring 2005, the SGP was revised so as to include more **flexibility** over the circumstances under which member states may temporarily run deficits in excess of the three per cent reference value, and small adjustments were made to the time schedule.

The preventive arm of the SGP was strengthened by a more differentiated medium-term orientation of the rules. The new provisions ensured that due attention was given to the fundamentals of fiscal **sustainability** when setting budgetary objectives. In future, the medium-term budgetary objective of a country is to be based on its debt ratio and potential growth. In practice, this means that countries with a combination of low debt and high potential growth are able to run a small deficit over the medium term, whereas

a balanced budget or a surplus is required for countries with a combination of high debt and low potential growth. The preventive arm of the SGP was strengthened because member states committed to consolidate further their public finances when facing favourable economic conditions and accepted that the Commission is to give them 'policy advice' if this consolidation fails to occur. The new agreement was also more sensitive to the effects of efforts made by member states to make structural reforms. The SGP's corrective arm was also adjusted by allowing more room for economic judgements and leaving open the possibility that the one-year deadline for the correction of an excessive deficit could be increased to two years.

The first test of the new SGP came in the second half of 2008 when the global financial crisis upset markets and challenged the survival of the banking sector. Member state governments in the EU responded by guaranteeing the savings of consumers, buying out banks, and offering other stimulus packages. Due to their sheer size, public finances were affected by these national rescue operations. The rules of the SGP still applied, however, even if, because of the economic crisis, these countries were allowed to overshoot the reference value for the duration of the downturn. Once growth returned, they needed to satisfy the rules of a budgetary deficit of three per cent and there are stricter rules if member states have a public debt in excess of 60 per cent.

The global financial crisis, the economic **recession**, and the sovereign debt crisis changed the perceived importance of the role of the SGP in guiding EMU. Some of the rules were strengthened (see Chapter 26 and 'The global financial crisis and the sovereign debt crisis').

KEY POINTS

- The aftermath of the signing of the Maastricht Treaty posed challenges to creating economic and monetary union, including treaty ratification difficulties, the exchange rate mechanism crisis, and difficulties meeting the convergence criteria.
- Some member states have had difficulties avoiding excessive deficits.
- Difficulties implementing the Stability and Growth Pact led to a crisis, and subsequently to its revision.
- Government spending led to an increase in debts and deficits in the EU, which had to be addressed.

Explaining economic and monetary union

This section considers two ways in which economic and monetary union can be explained from an economics and from a political science perspective.

An economics perspective

In the field of economics, there are two schools of thought that offer analytical tools with which to determine whether or not it made sense for the EU to create an EMU. The first argues that countries should create an EMU only if they constitute a so-called 'optimum currency area' (OCA). Countries should adopt a single currency only when they are sufficiently integrated economically, when they have mechanisms in place that can deal with **transfer payments** if one part of the currency union is affected by an economic downturn and the other part is not, and when they no longer need the exchange rate instrument to make those adjustments. Most analysts claim, however, that the EU is not an OCA, although a few think that a small number of its members come close to it. OCA theory states that if countries do not form an OCA, they should not give up their exchange rate instrument, but use it to make adjustments as the economic situation dictates. These analysts argue that the EU should not have moved to EMU. Others who judge that the EU does indeed constitute an OCA are less critical of this situation. They see the current group of countries as being well integrated. Furthermore, they use a broader definition of an OCA, claiming that original OCA theory is too rigid and pointing out that, following the original definition, no federation (including Canada, Germany, or the US) would constitute an OCA. Finally, some argue, following Frankel and Rose (1998), that once countries join EMU, they could become an OCA over time ('endogenous' OCA theory). Other developments that have influenced recent thinking about the role of exchange rates are the effects of financial markets on exchange rate policies—particularly on smaller open economies. Foreign exchange markets can create their own disturbances, which can be irrational. This effect is worse for smaller open economies than for larger established countries. The original OCA theorists did not take the destabilizing effects of exchange rate freedom into consideration.

A second school of thought focuses on central bank credibility. It argues that the EU witnessed long

periods of collaboration in central banking prior to EMU. Central banks can be effective only if financial markets have confidence in their policies. In the case of the exchange rate mechanism, participating countries had to keep their exchange rates stable. They focused on the monetary policy of the strongest currency, the German Deutschmark. Many individual central banks, by choice, followed the policies of the leader (the *Bundesbank*). The most credible way in which to secure monetary policy is to commit firmly to it in a treaty. That is, in fact, what happened with the Maastricht Treaty. A regime was set up that envisaged full central bank independence and gave the ECB a clear single mandate to maintain price stability.

A political science perspective

Political science has drawn on European integration theories (see Chapters 4–6) to explain EMU. It is noteworthy that scholars from opposing schools of thought have argued that EMU can be explained using different theoretical approaches. For reasons of simplicity, this section focuses on the two opposing schools in order to capture a larger set of arguments.

A **neo-functionalist** explanation (see Chapter 4) claims that EMU can best be explained as the result of **spillover** and incremental policy-making. The success of the exchange rate mechanism and the completion of the single market necessitated further collaboration in the area of monetary integration. EMU was needed to maximize the benefits of these developments. Significant monetary **policy convergence** had occurred, arising out of the collaboration within the framework of the ERM and the tracking of German policies by other member states. Hence EMU could be seen as a natural step forward. Moreover, it is argued that supranational actors were instrumental in creating EMU—which is another characteristic of the neo-functionalist explanation of European integration. Not only were the Commission President and the services of the Commission (such as the Directorate-General for Economic and Financial Affairs) involved, but also various committees, such as the EC Monetary Committee (created by the Treaty of Rome), and they each proved influential.

An **intergovernmentalist** explanation (see Chapter 5) argues that EMU can best be understood by examining the interests and bargaining behaviour of the largest member states. This approach sees the European Council meetings and meetings of the EU Council as crucial for decisions such as the creation of EMU and for follow up regulations. By examining the interests of the largest member states, one is able to see why EMU happened. France was in favour of EMU as a way of containing German **hegemony**. Germany, in turn, was able to secure a monetary policy regime that was sufficiently close to its domestic regime. Some argue that Germany was in favour of EMU in the early 1990s to signal its full commitment to European integration, following German unification. The UK was not in favour of EMU, but was aware that it was likely to happen. The UK wanted to be involved in **agenda-setting**, in shaping the process, and in ensuring EMU would not create a more federal political union at the same time. It has also been argued that EMU served the economic interests of the business communities within these countries, which subsequently led governments to be more supportive of the project.

KEY POINTS

- It is possible to explain economic and monetary union from different perspectives.
- Economists and political scientists have tried to explain economic and monetary union.
- Economists often use optimum currency area theory to assess EMU.
- Political scientists use theories of European integration to explain EMU.

Criticisms of economic and monetary union

Economic and monetary union is not without its critics, however. Criticisms may involve distinctive national perspectives, but can also rest on institutional grounds.

Countries outside the euro area

The Danes and Swedes are very proud of their political, social, and economic achievements, and many of them doubt that joining EMU will benefit their respective countries. A majority of their populations have been relatively sceptical about the euro and see joining the euro area as unnecessary or undesirable. In both countries, a referendum on EMU was held (in

Denmark, in 2000; in Sweden, in 2003) and in both cases the majority of those who voted were against joining EMU. Denmark has an opt-out agreed at Maastricht and thus can choose to stay outside the euro area; although the Swedish government does not have an opt-out, it pursues policies that guarantee that it does not qualify for EMU.

The UK reflects an even more **Eurosceptic** population. A large segment of the UK population has had doubts about European integration altogether. Many British citizens, the media, the Conservative Party, and of course the **UK Independence Party (UKIP)** seem deeply suspicious of policy-making in the rest of Europe, and fear they will have to make too many changes if they follow the lead of other European states.

The global financial crisis, the economic recession, and the sovereign debt crisis have had varying effects on member state perception of EMU. Initially, in 2007 and 2008, the euro fared better than did most of the currencies of EU member states that had remained outside the euro area. Yet, in 2009, 2010, and 2011 some member state currencies strengthened against the euro. But as currencies weakened, this benefited the export sector and was regarded as a factor that assisted in speedier recovery following the economic downturn or recession after the onset of the financial crisis. All in all, support for the euro has been varied. Over the past years, the Danish Prime Minister has indicated having more interest than before in joining the euro. In the UK, by contrast, attitudes still reflect the lack of interest by citizens and politicians alike.

The ten member states that joined the EU in 2004 have also had varying attitudes to euro adoption. The seven that have joined to date (Slovenia, Cyprus, Malta, Slovakia, Estonia, Latvia, and Lithuania) have been keen to do so. Those that have remained outside have done so for a variety of reasons. Some have a government and population that are reluctant (for example, the Czech Republic); others are currently unable to join because they have suffered from the crisis and are very far removed from meeting the criteria for entry, which focus on inflation, deficit, debt, long-term interest rates, and participation in the exchange rate mechanism (for example, Hungary). Poland can be seen as a country in the middle, where the ruling government is more positively inclined towards euro adoption and most of the convergence criteria could be met. Here, the obstacles are more domestic. The government will need support from the opposition to change the Constitution to join EMU. Another difficulty would be having the Polish *zloty* be in the ERM for two years. In all cases, these countries have the formal requirement that they are obliged to join EMU once they meet the criteria. It should be noted that this is a formality, because countries, such as Sweden, that choose not to join the ERM can stay outside the euro area simply by having their currencies not enter the ERM.

Criticism of EMU's institutional design

EMU has also been criticized for its poor institutional design. Critics argue that the extreme independence of the European Central Bank may lead to problems of **legitimacy** and **accountability**. The argument is developed in three steps. First, the ECB is more independent than any other central bank in the world. Its independence and its primary mandate (to secure price stability—in effect, low inflation) are firmly anchored in the Treaty. It also stipulates that no one is allowed to give instructions to the European Central Bank, nor should it take instruction from anyone. Second, it is difficult to change the ECB mandate, because it requires a treaty change, which means that all EU member states would have to sign and ratify the changed treaty. Third, there are very few **checks and balances** in place to ensure that the policies pursued by the ECB are those that the member states would have chosen—except for the one clear one, to secure price stability (low inflation). Even on that issue there is not much control: the ECB President gives quarterly reports to the European Parliament, but the EP cannot give instructions to the ECB. Thus one has to trust that the ECB will pursue policies in accordance with its mandate and that the policy outcome will benefit the EU as a whole. Fourth, no supranational institution can pursue flanking policies that may correct imbalances occurring as a result of the policies pursued by the European Central Bank.

Let us clarify this fourth issue a little further. Compared to mature federations, the institutional design of EMU is incomplete: there is a strong ECB that decides monetary policies for the entire euro area, yet there is no equivalent supranational economic institution that sets economic policies for that same area. Budgetary and **fiscal policies** remain in the hands of national governments. Although countries such as France argued strongly in favour of creating such

a *gouvernement économique* ('economic government'), the choice was made not to go down that route.

What are the advantages and disadvantages of having a European economic government? The advantages would be that policies could then be pursued to correct imbalances throughout EMU that result from a strict monetary policy (one that focuses on combating inflation). However, an economic government would make sense only if a majority of the citizens of the euro area were to feel comfortable with it. If it were not to have that support, then a decision by such a body would be deemed illegitimate. The current situation in Europe is that most citizens feel most comfortable with their national government taking on the role of taxing and spending.

KEY POINTS

- Denmark, Sweden, and the UK have not wanted to participate in economic and monetary union.
- There has been criticism of the institutional design of EMU.
- Some concerns relate to the independence of the European Central Bank and how this raises questions about legitimacy and accountability.
- The institutional design of EMU has also been criticized for being incomplete and falling short of 'an economic government'.

The global financial crisis and the sovereign debt crisis

In 2007–08, a major financial crisis hit the global economy. The crisis was caused by a series of problems, many of them originating in the USA. However, the financial crisis and its aftermath affected the EU even more than it did the USA. After the collapse of investment bank Lehman Brothers in September 2008, stock exchanges dropped, credit dried up, and many banks were at risk of collapse. National governments responded by guaranteeing deposits, (partially) nationalizing banks, and by putting together rescue packages. In 2009, the real economy shrank. In the EU, almost all countries were showing negative growth or were in recession (defined as two successive quarters of negative growth). As the economic recession took hold of the EU, many member state governments chose to spend considerably more than they taxed, leaving them with high deficits and public debt. Some countries experienced problems in securing money in capital markets to refinance their debt (see Chapter 26). This situation posed immense challenges for the euro area, through pressures on financial markets, pressure on interest rates for governments to attract funds in capital markets, and vicious circles of lack of confidence in markets and government policies. The result was a major crisis in the EU and a need to create new institutions, such as the **European Financial Stability Facility (EFSF)**, the forerunner of the **European Stability Mechanism (ESM)** that was to become operational in summer 2012, and changes to rules of the Stability and Growth Pact aimed at ensuring that governments will avoid excessive deficits and debt situations.

The changes to the Stability and Growth Pact (SGP) were substantial. On 11 December 2011, the reinforced SGP entered into force. The so-called 'six pack' (five regulations and one **directive**) includes rules that will kick in if member states fail to comply with the three per cent deficit and/or 60 per cent debt criteria. Some of the 'reinforced' rules include that the role of the debt is now taken to be as important as the deficit. In the past, the debt criterion was largely ignored. Another 'reinforced rule' is that it requires a qualified majority vote (QMV) to stop the sanctions (whereas before it required a QMV to impose sanctions on a member state that was facing financial sanctions). The changes to the SGP also provided the European Commission with a larger supervisory role in guiding member states through the fiscal year and ensuring sound policies over the medium term.

In 2012, two further regulations were introduced to strengthen euro area budgetary surveillance. These entered into force in May 2013 and both increased the coordination of budgetary policies in the euro area starting with the 2014 budgetary cycle. The Treaty on Stability, Coordination and Governance (informally referred to as the '**Fiscal Compact**'), came into effect in January 2013. The Fiscal Compact is an intergovernmental treaty that was put in place to ensure even stricter compliance with SGP rules. The Treaty envisaged what were called 'balanced budgets provisions' (no more than three per cent budgetary deficit and other rules related to the debt-to-GDP-ratios) which were incorporated in domestic constitutions. The Treaty also envisaged fines if member states failed to comply with these rules. A new term,

Denmark, in 2000; in Sweden, in 2003) and in both cases the majority of those who voted were against joining EMU. Denmark has an opt-out agreed at Maastricht and thus can choose to stay outside the euro area; although the Swedish government does not have an opt-out, it pursues policies that guarantee that it does not qualify for EMU.

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'**European semester**', was introduced in 2010 to capture this process of European Commission supervision of member state public finance over a six-month period. Finally, a so-called **Banking Union** was created to strengthen and extend the regulation of the banking sector. Its aim was to ensure that there was centralized supervision and resolution of banks in the euro area. Its four aims are a single rulebook for regulation of banks in the 28 member states; a **Single Supervisory Mechanism (SSM);** a harmonized system of deposit guarantee schemes; and a **Single Resolution Mechanism**, to provide a framework for banks in danger of failing. The rules were put in place to prevent bank crises, for example, by increasing the amount of funds that banks were required to hold (recapitalization). It also ensured that consumers' deposits across the EU were guaranteed up to €100,000 in case of a bank failure (see Chapter 26).

KEY POINTS

- The global financial crisis posed major challenges to the euro area.
- Most countries in the EU faced recession following the global financial crisis.
- The EU's reaction to the crisis involved new institutions, including changes to the Stability and Growth Pact, which increased the supervisory role of the Commission.
- The European Council agreed to the creation of a Banking Union in June 2012.

Conclusion

It has taken more than 30 years to create economic and monetary union. It was a long and slow process that ultimately led to the creation of a single monetary policy, the European Central Bank, and rules on budgetary policies and public debts. The introduction of the euro was based on a lengthy and gradual process of learning about economic and monetary cooperation. Not only was it necessary for countries to have met the convergence criteria, but it was also crucial that member states maintain stable exchange rates and that they agree on common goals for EMU.

Economic and political motivations lay behind EMU. Although one can make a case for a purely economic rationale for monetary union, its ultimate creation cannot be understood without an appreciation of its political dimension. EMU is a new stage in European integration. It signals the capability of EU member states to take firm action together and it places the EU more clearly on the international map. Yet a number of issues remain unresolved. In discussing the asymmetrical EMU, the chapter has indicated how fragile the balance is between 'economic' and 'monetary' union. The sovereign debt crisis has also unearthed challenges in EMU institutional design. Facilities were put in place to deal with some of the problems created by the euro area crisis, such as the European Stability Mechanism and the Banking Union. Yet it is not unthinkable that, in the future, further integration might be needed in the area of 'economic union' or that steps will have to be taken towards further political unification, if only to redistribute more evenly the costs and benefits of EMU. At the same time, we have seen that European integration is a gradual process, which lacks legitimacy if pushed ahead too quickly (see Chapter 24).

What will the future of the EU be with EMU in place? The continuing presence of the euro may well give the EU a stronger position in world politics, if only because it might offer an alternative to the US dollar (but see Chapter 15 on this point). As such, the euro contributes to the symbolism of European integration. It offers a concrete token representing the rapid and far-reaching process of integration taking place in the EU.

The regional use of the euro has increased quite rapidly from being legal tender in 11 member states in 1999 to 19 member states in 2015. Furthermore, it is conceivable that EU member states, such as Denmark, may want to join the euro area in the not-so-distant future, as will more of the Central and East European countries, thereby adding more to the euro's credibility and strength. Yet not all monetary unions in the past have lasted; EMU will survive only if it continues to be supported by the citizens, and by national and European politicians. Leaders will have to keep listening to the needs of their citizens. If they do so satisfactorily, the euro may well continue to have a very promising future.

QUESTIONS

1. Why was the term 'economic' and 'monetary' union used? What is an 'asymmetrical EMU'?
2. What are the various stages of economic integration from a free trade area to full political unification and what does each stage entail? Do all stages have to be passed in sequence?
3. What are the 'convergence criteria' and why were they invented?
4. Why has the Stability and Growth Pact been difficult to implement?
5. What are two opposing political science theories explaining why EMU happened? Do you agree that they are opposing theories or are they complementary?
6. What are the main criticisms of EMU?
7. Discuss how the creation of EMU was both an economic and politically driven process.
8. How have the global financial crisis, the economic recession that followed, and the sovereign debt crisis impacted EMU governance?

GUIDE TO FURTHER READING

Dyson, K. and Featherstone, K. (1999) *The Road to Maastricht: Negotiating Economic and Monetary Union* (Oxford: Oxford University Press) An influential political science volume, which examines the road to economic and monetary union based on hundreds of interviews.

Dyson, K. and Quaglia, L. (eds) (2010) *European Economic Governance and Policies: Volume I—Commentary on Key Historical and Institutional Documents*; (2011) *European Economic Governance and Policies: Volume II—Commentary on Key Policy Documents* (Oxford: Oxford University Press) Two 800+-page volumes containing key documents, with annotations.

Heipertz, M. and Verdun, A. (2010) *Ruling Europe: The Politics of the Stability and Growth Pact* (Cambridge: Cambridge University Press) A comprehensive account of the genesis of the Stability and Growth Pact, the 2003 crisis, and 2005 reform.

Hodson, D. (2011a) *Governing the Euro Area in Good Times and Bad* (Oxford: Oxford University Press) A short book that offers an oversight into the past, present, and future of governance of the euro area, written in language accessible to the non-specialist.

Verdun, A. (2000) *European Responses to Globalization and Financial Market Integration: Perceptions of Economic and Monetary Union in Britain, France, and Germany* (Basingstoke: Palgrave Macmillan) A volume examining perceptions of EMU from the perspective of the member states and considering how actors use EMU to serve or frustrate their interests.

WEBLINKS

http://ec.europa.eu/economy_finance/ The website of the European Commission's Directorate General for Economic and Financial Affairs (DG ECFIN).

http://www.consilium.europa.eu/en/council-eu/configurations/ecofin/ The website of the Economic and Financial Affairs Council (ECOFIN).

https://www.ecb.europa.eu/home/html/index.en.html The website of the European Central Bank.

http://www.consilium.europa.eu/en/council-eu/eurogroup/ The website of the Eurogroup.

http://ec.europa.eu/finance/general-policy/banking-union/index_en.htm The European Commission's website explaining the Banking Union.