The Euro under Scrutiny: Histories and Theories of European Monetary Integration

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Kenneth Dyson, *The Politics of the Euro-Zone. Stability or Breakdown?* (Oxford: Oxford University Press, 2000), 311 pp., ISBN 0-199-24164-3.

Kenneth Dyson and Kevin Featherstone, *The Road to Maastricht. Negotiating Economic and Monetary Union* (Oxford: Oxford University Press, 1999), 860 pp., ISBN 0-198-28077-7.

Peter Henning Loedel, *Deutsche Mark Politics: Germany in the European Monetary System* (London: Lynne Rienner, 2000), 264 pp., ISBN 1-555-87835-0.

Kathleen R. McNamara, *The Currency of Ideas: Monetary Politics in the European Union*, (Ithaca: Cornell University Press, 1998), 200 pp., ISBN 0-801-43432-7.

James I. Walsh, *European Monetary Integration and Domestic Politics. Britain, France, and Italy* (London: Lynne Rienner, 2000), 182 pp., ISBN 1-555-87823-7.

Amy Verdun, *European Responses to Globalisation and Financial Market Integration* (London: Macmillan, 2000), 260 pp., ISBN 0-333-71708-2.

Prior to 1989 only a few academics had been interested in a project which was widely discussed in European politics since the 1960s but which appeared almost as utopian as German reunification, particularly after the first attempt at creating a European monetary union, the Werner plan, failed miserably in the early 1970s. In the aftermath, euro-pessimism was widespread and given the apparent sclerosis of European institutions in the 1970s and early 1980s, an ambitious endeavour such as monetary integration seemed completely out of reach. The failure to stabilise intra-European exchange rates in the so-called 'snake' and the rocky first years of the European Monetary System (EMS) provided enough evidence for this pessimism.[1] It was furthermore underpinned by economic analysis. Professional economists thought that Europe was not fit for monetary union as long as it was lacking the characteristics of an optimum currency area (OCA). In a monetary union, the participating entities lose the instruments of exchange rate adjustment and of independent interest rate policy, therefore monetary adjustment has to come by

[1] The classic history of the early years of European monetary integration is Loukas Tsoukalis, *The Politics and Economics of European Monetary Integration* (London: Allen & Unwin 1977).

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other means such as labour market flexibility or fiscal transfers.[2] In contrast to the United States, however, there is only a relatively low degree of factor mobility among the European states and no centralised body for decision-making on macro-economic policy and/or eventual fiscal transfers. According to OCA theory, this has condemned any attempt at monetary integration to failure (many economists doubt the success of the euro with the same argument). Political scientists were equally sceptical. Most of them subscribed to the thesis of the German government that only with a higher degree of political union could a monetary union be viable (the so-called coronation theory).

However, despite these pessimistic assessments, European politicians kept the project on the agenda. It was particularly Europe's dependence on the vagaries of American dollar policy and the concomitant pressure on intra-European exchange rates which sparked new attempts at co-operation. The ups and downs of the dollar unsettled intra-European exchange rates and did considerable damage to existing European programmes, such as the Common Agricultural Policy, which depended on fixed prices across the member states. Growing capital mobility, decisively accelerated by the Single European Act (SEA) of 1988, increased the general volatility among European currencies and threatened to unsettle the domestic economic autonomy of governments. Still, few believed that the Europeans were really ready to go beyond loose cooperation and surrender their sovereignty in such a vital domain of state autonomy such as currency policy. When it suddenly became clear after 1989 that most members of the European Community were in fact willing to embark on 'the most important act in European institution-building since the Treaty of Rome in 1957' (Dyson, *Euro-Zone*, p. 1), scholarly interest took a sudden surge, particularly among political scientists.

This new research reproduced the cleavages which had existed in traditional research on European integration. Both (neo-)functionalist and intergovernmental arguments[3] were employed to answer the question: whence did European Monetary Union (EMU) come and where will it go? In the inter-governmentalist tradition, realist authors emphasise the influence of high politics and geopolitical developments, whereas liberal intergovernmentalists stress the primacy of domestic commercial interests. Functionalist theory argues with the inexorable force of economic change and the spill-over effect of existing European programmes. A more recent body of literature stresses the role of ideological factors. The authors assembled here broadly represent all those camps, with Dyson and Featherstone providing an ambitious attempt at synthesis. Since 'comparative politics' made its entry into European integration research, the field of inquiry has broadened to include questions of issues of governance, that is the actual functioning of the specific political system of Europe. These approaches are taken up by Dyson in his analysis

[2] Robert A. Mundell, 'A Theory of Optimum Currency Areas', *American Economic Review*, Vol. 51 (1961), 657–65.

[3] For a confrontation of these theories on the subject of EMU see Dieter Wolf, *Integrationstheorien im Vergleich: Funktionalistische und intergouvernementalistische Erklärung für die Europäische Wirtschafts- und Währungsunion im Vertrag von Maastricht* (Baden-Baden: Nomos Verlagsgesellschaft, 1999).

of the newly created euro-zone. Both in traditional and newer research, normative questions are implicit. They concern essentially the issue of the legitimacy of an EMU which will deeply interfere with national policies despite a lack of democratic accountability. Particularly important is the debate about the fate of the traditional European welfare state in Euroland.[4]

The fact that the creation of EMU paralleled the revolution in world politics after 1989 has led many analysts to conclude that both phenomena were closely connected. EMU was seen as a French strategy to embed the dramatically growing German power in a European framework by neutralising its most powerful instrument, the Deutsche Mark (DM).[5] Germany, on the other hand, used monetary integration for purposes of self-containment, as, for example Thomas Pedersen argues: 'Balance of fear considerations dictated that Germany pay a price for unification, the price being defined by the French as a reinforcement of the co-operative element in German hegemony.'[6] Peter H. Loedel's *Deutsche Mark Politics* presents a modified version of this realist argument. His study concentrates on the reasons why Germany should give up the Deutsche Mark, the symbol of its rise from the ruins of the Second World War, and to accept in return a European currency whose credibility had to be built up from scrap. A close examination of German domestic and international monetary policy since the mid-1980s, based on a comprehensive evaluation of press articles, provides the empirical background.

'DM politics' was made almost exclusively by two actors, the government and the Bundesbank, with the latter playing a pre-eminent but not predominant role in this process. Its result, Germany's international monetary policy, was situated in a triangle between international monetary relations on a G-7 level, the exigencies of European integration and the domestic priorities of DM politics. The major challenge for German monetary policy in this triangle was the requirement to balance national monetary autonomy and exchange rate stability in a G-7 and a European context. Whereas the highest possible monetary autonomy was crucial for the Bundesbank in order perfectly to pursue its statutory goal of price stability, the government, due to wider foreign policy concerns, often attached a higher value to exchange rate co-operation and was prepared to sacrifice some autonomy for the sake of this goal. The government was further concerned about the increasing strength of the DM, which led to considerable uncertainty for German export industries. German participation in exchange rate stabilisation was pursued simultaneously in a transatlantic and European context. In the mid-1980s, however, European co-operation intensified and provided a stronger incentive to compromise domestic autonomy, whereas German disenchantment with US monetary policies grew continuously. This was aggravated by the lack of formal institutions and the

[4] On this issue, see Bo Stråth, ed., *From the Werner Plan to EMU* (Frankfurt/Brussels: Peter Lang, 2001).

[5] Michael J. Baun, *An Imperfect Union: The Maastricht Treaty and the New Politics of European Integration* (Boulder: Westview, 1996).

[6] *Germany, France and the Integration of Europe: A Realist Interpretation* (London/New York: Pinter, 1998), p. 120.

ad hoc character of G-7 co-operation (the United States itself had done much to dissolve the institutional framework of the Bretton Woods system). Thus an increasing gap was opening between a thinner commitment to co-operation with the United States and the increasing need for close collaboration in the European context. The success of the European Monetary System (EMS) and the integration of European markets led to more intense pressure on the Bundesbank by the federal government to give up domestic autonomy for the sake of the stabilisation of European exchange rates. In this sense, Loedel endorses the traditional neo-functionalist argument for integration. However, in the end, this structural momentum was not enough for Germany's decision to give up the DM. Reunification and the need for a self-containment of the new German power in central Europe were the decisive arguments persuading German leaders to abandon the DM: 'The DM would, as it turned out, become the victim of European, and in particular French, support for German reunification' (*Deutsche Mark Politics*, p. 111).

In compensation, Germany used the interest of its neighbours in escaping the structural power of the DM to export to the EU countries its own monetary principles in the form of the Maastricht criteria and the stability pact. The other EU states had to follow the German model regarding the structures of the new institutions – a choice which required enormous institutional transformations such as the liberation of central banks from government control, stringent budgetary policies to fulfil the convergence criteria of the Maastricht treaty, and the acceptance of the German priority for price stability as the core focus of macro-economic policy. Thus, Loedel identifies a parallel process of a 'Germanisation' of European monetary policies and a 'Europeanisation' of Germany's monetary policies. To him, the Maastricht process essentially was an outcome of great power politics.

A growing body of work, however, discards this geopolitical explanation as insufficient and simplistic, and stresses the role of ideas. Given the recent surge of work in International Relations Theory in this field it is not surprising that EMU has become a focus of this research.[7] Kathleen McNamara's *The Currency of Ideas* is its most prominent exponent. In her tightly argued study she explains the emergence of EMU with a neoliberal policy consensus that took hold of decision makers in Europe during the 1980s. Dramatically changing conditions on financial markets, particularly rising capital flows, de-legitimised Keynesian policies based on a high level of state intervention in the economy. Economic theory suggests that under conditions of high capital mobility states have to choose between the pursuit of autonomous domestic policies and giving priority to the defence of fixed exchange rates.[8] They can not have both, as, for example, the failure of the 'snake' showed when the widely diverging economic policies of the participating countries led to a rapid erosion of exchange rate stability. Thus, if the European countries wanted to

[7] For one such attempt, see: Thomas Risse *et al.*, 'To Euro or not to Euro? The EMU and Identity Politics in the EU', *European Journal of International Relations*, Vol. 5 (1999), 147–87.

[8] This theoretical proposition, termed 'Mundell's Holy Trinity', was pioneered by Robert A. Mundell, 'The Monetary Dynamics of International Adjustment under Fixed and Flexible Exchange Rates', *Quarterly Journal of Economics*, Vol. 74 (1960), 227–57.

stabilise intra-European exchange rates, they would have to forego autonomy in monetary decision-making. Neo-liberal thought provided a solution for this predicament. It argued explicitly against government intervention in the economy and emphasised the pursuit of low inflation over objectives of economic growth and full employment. An 'epistemic community' of political and financial elites was formed on a European level during the 1980s, which worked towards an institutionalisation of these ideas on a European level. The basic views of this group regarding monetary integration were remarkably stable, and they carried the EMU project over many hurdles which had doomed earlier attempts to failure. This is shown succinctly by Amy Verdun's book on the perceptions of monetary policy makers in Britain, France, and Germany (*European Responses*, p. 194). Based on this common outlook, almost all European countries pursued the necessary domestic reforms which made EMU economically sustainable. The successful German example of stability-oriented monetary policies provided a model in this respect. Its emulation by other European countries led to strong coherence which made EMU viable (*The Currency of Ideas*, pp. 5–6).

McNamara's argument is constructivist; that is, it is at variance with Loedel in that the interests of states are not given by their position in the international system or by their domestic economic conditions but they are constructed in a process of adapting to changing conditions. The acceptance of neoliberal ideas by almost all European countries slowly led to a convergence of economic policies. Taking a long-term perspective, this seems in fact a crucial factor in the creation of EMU. A problem of idea-based approaches is, however, that it is very hard to trace exactly the process through which ideas are diffused, particularly regarding short-term developments. Thus, although these approaches are convincing in explaining long-term change, there are difficulties in their encompassing short-term events such as the Maastricht treaty. Furthermore, the impact of domestic factors is rather neglected, although these are strongly stressed by many other analysts.

Andrew Moravcsik, for example, emphasises in his influential study of European integration the crucial role of domestic economic interest in the formation of EMU.[9] Only when the domestically determined interests of the European countries converged after a long process of bargaining was EMU possible. Ideological factors or geopolitical circumstances played a secondary role. However, Moravcsik's widely cited book lacks a clear description of how domestic interests in monetary matters are constructed and how they influence government policies. James Walsh's comparative study of the monetary policies of Britain, France and Italy in the EMS period (*European Monetary Integration and Domestic Politics*) tackles this issue. His analysis proceeds along two, somewhat disjointed, lines: on the one hand, he concentrates on the domestic sources of monetary policy and, on the other hand, he seeks to explain monetary policies in the international arena.

In contrast to the constructivist approach, Walsh detects no convergence of policy preferences around a neoliberal consensus. He sees a clear weakness of idea-

[9] *The Choice for Europe* (London: UCL Press, 1998).

based approaches in that they are not able to explain why in France, Britain and Italy the basic positions with regard to European monetary integration changed little in the period under research. Like Loedel, he maintains that the EMS and EMU worked not because other countries emulated the German model and moved towards a neoliberal consensus but because Germany was strong enough to establish its monetary policy preferences at a European level (p. 26). However, the argument that Maastricht represented a German concession in exchange for the acceptance of reunification is firmly rejected by Walsh. Echoing Moravcsik, he sees the EMS and EMU as primarily an externalisation of powerful domestic interests.

A large part of the analysis is dedicated to the formation of these domestic monetary preferences. They were not the outcome of a struggle between export-oriented industries, which prefer a competitive currency level, and those producing for the domestic market (which urge low import prices and a strong currency).[10] They rather corresponded with the nature of institutionalised links between banks and industry. Whereas in France and Italy banks, with their traditionally close links to industry, would not speak out strongly against devaluations prior to the 1990s, Britain with its independent financial sector was largely indifferent to industry's call for a lower external value of the pound and more interested in pursuing policies of low inflation. Only when the close links between banks and industry in France and Italy weakened during the 1980s did their governments embark on a policy of stabilising the external value of their currencies more in accordance with the model for monetary union preferred by Germany. The relevance of this probably correct observation for the formation of EMU, however, is not really elaborated, and all in all it seems a curiously one-dimensional explanation for monetary policy. We get an explanation of what might shape the monetary preferences of domestic groups, but we get little idea of the extent to which these domestic groups really influenced government policy. In fact, it seems that domestic economic groups such as banks or industry had very little influence on the outcome of the EMU process, as Dyson and Featherstone demonstrate. The real moving force on the way to Maastricht was a core executive group composed of government officials and central bankers. Sectoral interests had (and have) only little influence on monetary policy. In all likelihood, this factor was even a condition for the success of Maastricht. The efficiency of the negotiations was enhanced considerably because these questions were almost absent in the deliberations. The drawback of this fact, of course, is that many societal interests were not able to voice their views in the negotiations, thus opening a democratic deficit which will become virulent as soon as the euro-zone pursues policies which have a deep impact on the prerogatives of elected governments.[11]

This problem is clearly realised in Kenneth Dyson and Kevin Featherstone's

[10] This argument is advanced by Jeffry A. Frieden, 'Invested Interests: The Politics of National Economic Policies in a World of Global Finance', *International Organisation*, 3 (1991), 425–51.

[11] For the debate about the democratic deficit of EMU, see: A. Verdun and T. Christiansen, 'Policies, Institutions and the Euro: Dilemmas of Legitimacy', in Colin Crouch, ed., *After the Euro: Shaping Institutions for Governance in the Wake of EMU* (Oxford: Oxford University Press, 2000), 162–78.

monumental study, *The Road to Maastricht*, as well as in Verdun's book. The approach in both books is rather eclectic (which probably reflects the fact that these authors are of European origin; European academics seem not to share the predilection of their US counterparts for clear-cut dichotomies and parsimonious theories). Verdun's book is based on a range of interviews of high officials, including functionaries of associations of industry and trade unions. The interviews demonstrate that the range of expectations different actors placed on EMU was extremely diverse. Verdun therefore rejects one-dimensional economic or functionalist explanations for EMU and, based also on a historical overview, makes a plea for and gives an outline of an 'eclectic theory' of monetary integration.

The study by Dyson and Featherstone takes a similar approach. Existing theories of European integration are elegantly interwoven with an extremely detailed historical narrative based on the published record, some confidential documentation and over 200 interviews. The evolution of French, German, British and Italian policies as well as the position of the Commission is traced in a very readable, though sometimes repetitive account. The authors refute any single explanation for a multi-faceted enterprise such as EMU. They see no quasi-automatic logic at work leading to the Maastricht compromise. To be sure, the growth of capital mobility, the spill-over from European initiatives such as the SEA and the EMS, the macroeconomic expansion in Europe during the 1980s, the convergence of economic beliefs around a sound money paradigm and corresponding reforms in domestic economic structures created favourable conditions. Thus, the neo-liberal policy consensus identified by McNamara was crucial for the Maastricht agreement. Its basic premises were shared by a core executive group of finance ministers, central bankers and high officials which devised the details of the Maastricht treaty. Particularly important also was that these negotiations occurred in an environment in which divisive wider questions of political union and democratic accountability, which had been strongly contested during the Werner Plan negotiations,[12] were subordinated to the technical goal of making monetary union work. Nevertheless, without a strong political impulse anything more than loose monetary co-operation would not have been possible. The notions of binding in the new Germany and of creating a monetary rival to dollar hegemony were driving forces behind French policy. The failed experiment with a Keynesian strategy in the early 1980s helped France to accept the German blueprint for monetary union which placed emphasis above all on the political independence of the new central bank. German reunification helped to foster rapid agreement. The strong convictions of leaders such as the German Federal Chancellor Helmut Kohl and Mitterrand that monetary integration formed an integral part of the new European architecture carried the project over numerous hurdles. The fact that the EMU process was deeply embedded in the overall European security structure made loss of sovereignty acceptable to both

[12] The recent publication of German diplomatic documents for 1970 allows a first-hand glimpse of these controversies; see *Akten zur Auswärtigen Politik der Bundesrepublik Deutschland 1970*, 3 vols. (Munich: Oldenbourg, 2001).

France and Germany.[13] In the end, therefore, it was shared beliefs – geopolitical and economic – which were vital in achieving agreement.

The book gives ample room to detailed case studies of the most important actors in the Maastricht process. This includes not only the big three (Britain, France, Germany) but also Italy and the European Commission, which is accorded an important role as policy sponsor and driving force behind the agreement. Italy's motives in the Maastricht process were twofold. First, Italian politicians were determined to stay in the 'Serie A' of European integration. Second, they were able to use Maastricht as 'vincolo esterno', that is, a decisive argument in the domestic debate to pursue economic reforms which would otherwise fail due to political opposition in the country. The problem, however, in Italy as well as in other countries, is whether the impetus created by the desire to stay in the 'Serie A' can be carried over to the day-to-day management of the euro. There is little doubt that a main condition for the future of the new currency will be the resolve of the participating governments to continue with stability-oriented policies.

On 1 January 1999, the euro-zone came into being. As we have seen, the bulk of the literature on European monetary integration concentrates on how and why the euro was created, less on the working of the new currency zone. This field of inquiry is dominated by economists trying to assess the future stability of the euro-zone.[14] Usually they see the guarantee for the sustainability of the euro in the strength of the institutions which impede any compromising of the goal of price stability and ensure that credibility is maintained. Strong emphasis is placed on the flexible labour markets and supply side reforms which are suggested by OCA theory. Politics is to be excluded from economic decision making as far as possible. The prominence of such technical expertise in the creation of the euro-zone has led to a lack of attention to the political factors sustaining its stability.

This gap is addressed by Kenneth Dyson in *The Politics of the Euro-Zone*, his analysis of the new governance structure which has been established at the European level in the form of the European Central Bank (ECB) and its surrounding institutions. Research on governance in the European Union has taken a rapid surge in the past few years. The metaphors of 'multi-level-governance'[15] and network regimes[16] have come to dominate the field. Dyson employs these analytical instruments to describe the state of the euro-zone after its first year of existence, which is marked particularly by the wide-ranging autonomy given to its supranational level. Due to the by-now institutionalised features of an independent central bank with a clear overriding goal of price stability, the euro-zone is much more

[13] For a similar argument regarding the embedding of the Bretton Woods system in the Cold War security system see H. Zimmermann, *Money and Security. Monetary Policy and Troops in Germany's Relations to the United States and the United Kingdom, 1955–71* (Cambridge: CUP, 2001).

[14] D. Gros and N. Thygesen, *European Monetary Integration: From the European Monetary System to European Monetary Union* (London: Longman, 1992).

[15] M. Jachtenfuchs and B. Kohler-Koch, eds., *Europäische Integration* (Opladen: UTB, 1996).

[16] B. Kohler-Koch and R. Eising, eds., *The Transformation of Governance in the European Union* (London: Routledge, 1999).

resistant to intrusions by national governments than other European institutions. The Euro-11 group of finance ministers is far from the idea of an economic government supervising the central bank which had been propagated by France and other countries since the days of the Werner Plan. The defeat of Germany's ex-finance minister Oskar Lafontaine, who tried to argue the ECB into a more growth-oriented policy and a lowering of interest rates, provides an instructive example of the strength of this institutional arrangement. However, that does not mean that the euro-zone is completely isolated from societal pressures.

For the moment, acceptance of the reality of the 'competition state' [17] even by social democratic governments does sustain an emphasis on stability-oriented policies all across the euro-zone. But there are still huge differences among national policies, embodied for example in diverging welfare state models. The existence of these differing conceptions might easily undermine the consensus in the euro-zone. Arguing from a constructivist perspective, however, Dyson stresses that the ECB was not only a solution to problems of collective monetary action in Europe but was also informed by mutually shared ideas embodied in its institutions and discourse. The euro-zone therefore represents a Kantian culture, that is a political style based on compatible ideas, co-operative arguing and a search for common, non-competitive solutions which is at variance with the emphasis on relative gains by egoistic actors stressed by realist authors. For this reason, Dyson estimates the chances of the euro-zone optimistically (whereas Walsh, for example, sees EMU as an unfinished bargain underpinned by as yet not reconciled policy views, and therefore assesses more pessimistically the ability of the EMU countries to accommodate economic shocks and policy divergences). Of course, such forecasts are still very preliminary, as Dyson himself admits; a much broader empirical base from which to assess the reaction of the new institutions to various scenarios is necessary before precise predictions become possible. However, *The Politics of the Euro-Zone* masterfully pioneers the study of governance in the euro-zone and provides a series of crucial questions which will stay on the agenda.[18]

As this review has demonstrated, the debate on whether the euro will be successful in the long run is still far from having reached a consensus. Until now the euro has proved strong in the domestic field but not yet an equal competitor to the dollar as reserve currency. After all, after the Second World War it took the dollar more than a decade to overtake the pound sterling as the world's most used currency. The complex process of the creation of EMU suggests that its success will depend on just as many different factors. Research by political scientists into European monetary integration has already generated an impressive range of empirical evidence and theoretical premises. When, with the progressive opening of archives, detailed historical research starts, it will not be an easy task for future historians to add substantially new evidence and interpretations to this debate.

[17] P. Cerny, *The Changing Architecture of Politics: Structure, Agency, and the Future of the State* (London: Sage, 1990).

[18] A drawback of the book, however, is that it was obviously produced very quickly: there are many repetitions, imprecise references, printing errors (even on the cover), and mistakes in the index.