The Political Economy of European Monetary Unification: An Analytical Introduction

Barry Eichengreen and Jeffry Frieden

European monetary unification — the process that led to creation of a single European currency (the euro) and a European Central Bank (the ECB) — is both an economic and a political phenomenon. It is economic in that monetary unification has far-reaching consequences for economic policy and performance Europe wide. Transactions costs have been reduced by the advent of the single currency, stimulating intra-European trade and capital flows. Interest-rate differentials have narrowed now that the separate monetary policies of the founding member states have been replaced by the single policy of the ECB.[1] European finance is being transformed by the explosive growth of euro-denominated bond issues, strategic alliances among national stock exchanges, and a continent-wide wave of bank mergers as the advent of the euro creates for the first time a truly continental financial market.

But EMU is also a political phenomenon. The decision to create the monetary union, the decision of whom to admit, and the decision of whom to appoint to run the ECB are political decisions, taken by political leaders, subject to political constraints, not the social-welfare maximizing decisions of some mythical social planner. They result from a political process of treaty negotiation, parliamentary ratification, and popular referendum. Individuals and interest

[1]While "Euroland," as the area comprised of the founding members is fondly known, is made up of 11 countries, they had only ten monetary policies, Belgium and Luxembourg having long since formed a monetary union.

groups support or oppose monetary unification — not just in EU member states that have not yet joined the euro area, but even now in the founding members — on the basis of how they perceive it as affecting their individual welfare, not the welfare of the nation as a whole, much less the welfare of the entire European Union.[2]

Despite the outpouring of research prompted by EMU, few accounts have systematically analyzed both its political and economic aspects. That is the goal of the present volume. The contributors describe both the political and economic dimensions of the process. They demonstrate how political constraints have shaped the design and operation of Europe's monetary union at the same time that the changes in economic structure brought about by monetary integration continue to transform European politics.

A Short History of European Monetary Unification

Monetary unification has always been at the center of the larger process of European integration. Economically, the creation of a single currency was long seen as necessary for forging a truly integrated European market. Politically, monetary unification has been seen as a practical and symbolic step toward the development of a capacity to formulate social and foreign policies at the European level. Both advocates and opponents of further European political integration have long regarded monetary integration as the thin end of the wedge. For all these

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[2]Throughout this essay, we use the term "European Union" even where the organization was at the time going by another, earlier, name.

reasons, the desirability of European monetary unification has been contested since the idea was first mooted.

Serious discussion of monetary unification goes back to the 1960s.[3] In 1969 the Werner Report set forth an ambitious plan for a three-step transition to monetary union to be completed within a decade. In the event, its blueprint was rendered obsolete within weeks by the slow-motion collapse of the Bretton Woods international monetary system. When the Bretton Woods system of par values, which had provided a framework for holding European exchange rates within fluctuation bands of plus or minus 2 per cent, finally collapsed in 1971, the European Community's six founding member states had to focus their energies on limiting the volatility of their exchange rates, lest complaints of arbitrary and capricious changes in competitiveness undermine European solidarity. They resolved to hold their currencies within 2 1/4 per cent bands (only slightly wider than those they had operated under Bretton Woods). They were joined in the "Snake," as this arrangement was prosaically known, by the UK, Ireland and Denmark as those three countries prepared to become members of the European Union.[4]

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[3]Even at this early date, plans for monetary union were linked to broader political problems associated with French ambivalence about the European Community in the aftermath of the franc crisis of 1969. On early monetary plans, see Tsoukalis (1977) and Ypersele (1985). For surveys of the process of monetary integration more generally, see Fratianni and von Hagen (1992), and Gros and Thygesen (1998).

[4]Norway and Sweden also tied their currencies to the mechanism. On the snake, see Tsoukalis (1977), Ludlow (1982), and Coffey (1987).

Soon, however, divergent economic conditions and policies, reflecting the impact of the first oil shock in 1973-4, rendered the Snake unworkable. The least committed members suffered repeated balance-of-payments crises, forcing them to alter or abandon their currency bands. By 1975 only Germany, the Benelux countries, and Denmark remained in the snake. The European countries whose policies diverged most from Germany's — the UK, Ireland, France and Italy — simply left, and the Danes were able to remain only by virtue of serial devaluations.

Discussions of monetary unification resumed once this turbulence had passed. The outcome was the establishment of the European Monetary System (EMS) and its Exchange Rate Mechanism (ERM) in March 1979. All EU member states except the UK participated in the ERM, linking their currencies via a multilateral parity grid which again allowed for fluctuations of plus or minus 2 1/4 per cent.[5] Provision was made for realignments, although these were expected to be rare. Financing facilities were provided for countries attempting to stablize their exchange rates in the face of balance-of-payments shocks, and capital controls were relied upon to limit speculative pressures.

Conventional wisdom at the time was that the EMS was unlikely to succeed. The inflation rates of the participating countries differed widely. High-inflation countries had demonstrated an inability to put in place the measures needed to stabilize their currencies against

[5] 6 per cent for the Italian lira.

the deutschmark. Faith meant believing that the creation of the EMS itself would strengthen the willingness of high-inflation countries to pursue painful policies of austerity.

Initially, skepticism seemed more than justified. In the first four years of the EMS, balance-of-payments pressures were intense. Exchange rates were realigned seven times, and there were few signs of monetary convergence. Then, however, the outlook began to brighten. Rates of price increase in the high-inflation countries began to decline. From April 1983 to January 1987 there were only four realignments, generally smaller than those which had come before. And from January 1987 to September 1992 there were no major realignments within the ERM. Attracted by its improved performance, Spain, Portugal and the UK all joined the mechanism in this period.

This transformation was stimulated by, and stimulated in turn, progress on the larger project of European integration. The Single European Act of 1986 called for the removal of controls on the movement of goods, capital and persons within the Union. A true common market, in which only countries with well-behaved exchange rates would be permitted to participate, created the prospect of additional rewards for ERM participation. And by mandating the removal of capital controls, the Single European Act pointed up the need for further policy convergence in order for the stability of exchange rates to be maintained.

In this context, and specifically in response to calls by the French and German foreign ministries, the European Council appointed a committee in 1988 headed by European Commission President Jacques Delors to investigate the prospects for further monetary integration. The Delors Committee recommended that the EU begin moving immediately toward the creation of a single currency. The next step in this process came at Maastricht in the Netherlands in December 1991, when the member states agreed to a sweeping treaty on economic union, giving diplomatic content to the recommendations of the Delors Report.

The Maastricht Treaty, echoing the Delors Report and the Werner Report before it, sketched a transition in three stages. Stage I involved the elimination of Europe's remaining capital controls, the accession of all EU members to the ERM, and hardening of the exchange-rate commitment. In Stage II, with the EMS credible and encompassing, member states would reinforce the independence of their national central banks and strive to satisfy a set of "convergence criteria" designed to facilitate the harmonization of their economic policies and to distinguish member states prepared to live with the consequences of a single monetary policy from those lacking the requisite commitment. A European Monetary Institute would be created to lay the groundwork for the establishment of the ECB. Finally, in Stage III, to commence no later than the beginning of 1999, the European Central Bank would begin operations, to be followed in three years by the issuance of euro banknotes and coins.

With a plan in place and all EU members but Greece participating in the ERM, it appeared that the single currency was only a matter of time. But while Europe's political leaders had had their say, the markets and voters were still to be heard from. The backdrop for their intervention was German reunification, underway since 1990. The costs of reunifying the two Germanys gave rise to huge budget deficits for the Federal Republic, which excited fears of inflation in the corridors of the Bundesbank. The response of the latter was to raise interest rates. But high interest rates were uncomfortable for Italy, whose debt and deficits were large. They were uncomfortable for the UK, where mortgage interest rates were indexed, whose business cycle was not synchronized with that of the rest of Europe, and where the commitment to European integration was less than firm. More generally, chronically high unemployment rates, which by the early 1990s had become a fact of Europe's economic and political life, made it difficult for governments to stomach high, German-style interest rates. The result was pressure on sterling, the lira and other weak European currencies in the summer of 1992.

In the midst of this gathering storm, public opposition to the Maastricht Treaty materialized. The failure of Danish voters to ratify the treaty in that country's June 1992 referendum and fears that a subsequent referendum in France might also fail raised the possibility that the entire Maastricht process might be derailed. An indefinite postponement of EMU would have rendered it all the more unlikely that high-unemployment countries would be prepared to stay the austerity course. Knowing this, the markets pounced. Despite committing billions of dollars to their battle with currency-market speculators, the Bank of England and Bank of Italy were forced to surrender to the markets. On September 16th, 1992, their respective governments withdrew from the ERM and allowed their currencies to depreciate.

Having toppled two of Europe's larger currencies, speculators turned their attention to the smaller ones. Yet more crises and realignments then drove the currencies of Spain, Portugal and Ireland downward.

Unsettled conditions persisted into 1993. In the summer, with unemployment continuing to rise continent wide, the pressure intensified for interest rate reductions. None of this deterred the Bundesbank, still preoccupied by inflation, from maintaining a tight monetary stance that prevented other EMS members from reducing their interest rates. The resulting dilemma was most serious in France, where a new government took office amidst the recession. The Bank of France attempted to lead by example, reducing interest rates in the hope that the Bundesbank would follow. In this they were disappointed. Inferring that the French authorities were unprepared to hold the line, currency speculators turned their fire on the franc. Massive intervention by the Bank of France failed to repel them. With pressure continuing to mount, European leaders were forced to acknowledge that the old narrow-band ERM had been rendered unworkable by the removal of capital controls, the liquidity of the markets, and the existence of other political and economic imperatives. But rather than abandoning the mechanism, they adopted the stopgap of widening its currency fluctuation bands from 2 1/4 to 15 per cent.[6] This removed the one-way bets that speculators had found irresistible (since currencies could now appreciate rather than depreciate if speculators turned out to be wrong), and gave governments more room for maneuver. At the same time, however, it raised questions about the capacity of EU member states to keep their exchange rates stable and, more fundamentally, their willingness to subordinate other social goals to a single monetary policy.

[6]The bilateral band for the deutschmark and the Dutch guilder, a currency whose stability was never in question, was kept at 2.25 per cent.

In this, Europe's darkest hour, fears were widespread that the Maastricht process was doomed. With only a weakened an exchange rate commitment to bind them, member states might fail to make progress on convergence. And if other EU member states failed to solve their inflation, debt and deficit problems, Germany would be unwilling to embrace them as partners in a monetary union. Most alarmingly of all, if exchange rates grew more volatile as policies diverged, the Single Market might be placed at risk.

This pessimism turned out to be exaggerated. Economic developments help explain why the convergence of policies and institutions between 1994 and 1998 turned out to be more successful than anticipated. By 1994 the shock of German unification had begun to recede, allowing the Bundesbank to reduce rates. The 1993 recession passed, and with the resumption of economic growth, fiscal consolidation and policy harmonization became easier to undertake.

Politically, the transition to EMU was eased by the strong demonstrations of support that plans for a single currency elicited following the 1992-1993 crisis. Even governments that had been forced to devalue reiterated their commitment to the completion of the monetary union, and despite the widening of the currency bands, most were indeed able to keep their currencies close to their central rates. Powerful business groups were vocal in support of EMU, arguing that the 1992-1993 devaluations had disrupted progress toward the Single Market and deeper integration. And electoral support for anti-European parties and candidates waned as economic difficulties receded.

Institutionally, inter-state negotiations allayed some of the fears of those who remained wary of EMU. A Growth and Stability Pact committed EMU members to avoid large budget deficits, thus extending the commitment to fiscal retrenchment beyond the creation of the single currency. This helped to pacify fiscal conservatives concerned about the profligacy of Southern European (and other) governments. At the same time, member states exhibited some flexibility in interpreting the fiscal criteria, which reassured those who worried that EMU would be too rigid a policy straitjacket. All in all, negotiations signaled that the architects of the monetary union were aware of the political constraints and willing to work within them.

Together, then, favorable economic conditions, political momentum, and institutional flexibility combined to make it possible for most EU member states to complete the fiscal retrenchment necessary to qualify for monetary union. While the letter of the convergence criteria was not always strictly met, European policy makers concluded that the aspirants had satisfied their spirit, and each of the 11 member states wishing to participate was deemed worthy when the decision was taken in 1998. Right on schedule, on January 1st, 1999, Europe's monetary union came into being.

The Economics of Monetary Unification

Most analyses of the economics of European monetary unification build on the theory of optimum currency areas, one of the contributions for which Robert Mundell was awarded the Nobel Prize in Economics in 1999. In Mundell's model, the benefits of monetary unification, which take the form of the reduction in transactions costs consequent on replacing distinct national currencies with a single (common) currency, are balanced against the costs of sacrificing monetary and fiscal autonomy. One might think that the savings in transactions costs are considerable. Tourists changing money at airports pay commissions amounting to anywhere from 2 to 5 per cent of the cash they exchange. But banks and firms doing larger volumes of business in wholesale markets pay much smaller commissions. And such costs, as a share of GNP, depend on the openness of the economy. European Commission estimates suggest that conversion costs absorbed about one per cent of national income for the EU's small, low-income countries but as little as one tenth of one per cent of national income for the large member states for which international transactions are less important. Overall, currency conversion costs averaged less than one half of one per cent of EU national income in the late 1980s. This, it would seem, is a modest return on a process riddled with risks and uncertainties.

It can be argued that the real efficiency advantages come not from the single currency but from the Single Market and that the two initiatives are linked. The Single Market allows European producers to exploit economies of scale and scope. By creating a Europe-wide financial market, it promises to stimulate efficiency-enhancing mergers of banks and securities exchanges. By heightening cross-border competition, it forces European producers to shape up or ship out. By intensifying regulatory competition, it compels European governments to remake their policies in market friendly ways. This is only one vision of the intentions of architects of the Single Market, to be sure, but it is a compelling one.

And the single currency is indispensable, the argument continues, if Europe is to reap the benefits of the Single Market. It enhances transparency. It makes it that much harder for automobile producers to charge different prices in different countries when a single unit of account allows consumers to more readily compare those prices across countries. It makes it harder for banks steeped in traditional ways to survive in sleepy national backwaters, insofar as the elimination of currency risk encourages savers to seek out higher deposit rates and investors to seek out lower loan rates abroad. It makes it harder for unions to insist on restrictive work rules, insofar as a single currency makes it easier for employers to compare labor costs and the elimination of currency risk facilitates the establishment of branch plants in member states where labor is less expensive and workers are more productive.[7]

At the same time, the efficiency advantages of a single currency must be balanced against the disadvantages of a single monetary policy. Those disadvantages take the form of the sacrifice of policy autonomy that comes with moving from 10 or more separate monetary policies to a single level of interest rates across the euro-zone. Recall how in 1992-3, when some European countries feared inflation but others were preoccupied by unemployment, the group as a whole found it hard to agree on a one-size-fits-all monetary policy. Asymmetric disturbances, like the

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[7]The benefits are likely to be considerable insofar as barriers to full price convergence appear to have persisted well into the 1990s. Indeed, the existence of different currencies appears to have been one of the principal obstacles to the emergence of a truly integrated market. This is demonstrated by Engel (this volume), whose results imply that a common currency could make a major contribution to the development of more fully integrated, and thus more efficient, goods markets in the European Union.

German reunification shock that was the source of the tension in 1992-3, can still occur under monetary union, but the member states now have no choice but to grin and bear them.[8] A single monetary policy may then mean uncomfortably high inflation for some but uncomfortably high unemployment for others. The question for those seeking to gauge the costs of monetary unification is how frequently such asymmetric disturbances will occur.

The standard way of gauging whether a given correlation of shocks to different national economies is high or low is to compare it with the correlation of the same variables across the various regions within a functioning monetary union, typically the United States.[9] By this measure, while the core members of the European Union (Germany, France, the Benelux countries and Denmark) are good candidates for monetary union, the same is less true of the EU periphery. The problem with this approach is that the shocks in question are likely to change with the advent of monetary union, rendering history a poor guide to the future. Demand shocks result from erratic changes in demand-management policy, whose formulation will be transformed by EMU. Asymmetric monetary shocks will disappear with the advent of a single monetary policy (although differences in the monetary transmission mechanism will remain). Asymmetric fiscal shocks will be limited by the Growth and Stability Pact. Supply shocks will

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[8]The divergence between the euro "core" and "periphery" (Ireland and Iberia on the one hand, Germany on the other) in the opening quarters of Stage III was one indication that this dilemma was real.

[9]A prototypical study of the incidence of aggregate supply and demand disturbances affecting different candidates for EMU, with comparisons to the United States, is Bayoumi and Eichengreen (1993).

be transformed as Europe reorganizes itself to capitalize on the single currency and the Single Market.[10]

Other optimum currency area criteria are less likely to be endogenous with respect to the policy regime. Mundell observed that the costs of subjecting several separate economies experiencing asymmetric shocks to a symmetric monetary policy will be less when labor flows freely from depressed to booming regions. His intellectual descendants pointed out that a single monetary policy is similarly less problematic when wages adjust downward in high unemployment regions, obviating the need to relax monetary policy to fight unemployment. So far, there is little sign that the hardening of the EMS constraint and the transition to EMU have transformed these aspects of labor-market performance. The mobility of labor between EU member states remains low, reflecting deeply entrenched cultural and linguistic barriers. Wages remain rigid, reflecting the inheritance of strong unions and generous social programs. Where economic arrangements are embedded in social institutions, as in the case of labor markets, they are slow to change.

The implication for Europe is not a happy one. Insofar as these rigidities are both serious and slow to change, the costs of monetary unification may be considerable. A shock which raises unemployment in one EMU member state but does not elicit a reduction in interest rates

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[10]Whether this last development makes supply shocks more or less asymmetric, and therefore raises or reduces the costs of monetary unification, is, unfortunately, uncertain. This is the "Krugman versus Krugman" debate, Krugman (1993) having argued both positions.

by the ECB, because it does not produce comparable unemployment elsewhere in the monetary union, may give rise to a problem of a chronically depressed region. This suggests that the politics of EMU may be more compelling than the economics, or at least that the decision to go ahead needs to be understood on political as well as economic grounds.

The Politics of Monetary Unification

A number of political factors are commonly adduced to help explain the course of European monetary integration. As a point of departure we distinguish inter-state bargaining and domestic distribution.

1. Inter-State Bargaining

Even if monetary union does not enhance the welfare of all countries, it still may be in the interest of some, which then cajole, coerce, or bribe others into participating. This approach, generally associated with what political scientists refer to as "intergovernmentalism," interprets observed outcomes as the result of strategic interaction among national governments.[11] Most of those who utilize this approach have in mind a process in which governments trade off objectives -- that is, they have in mind a form of "linkage politics." By linkage is meant the tying together of two (or more) otherwise unconnected issue areas, permitting the parties to an

[11]For summaries and applications of "intergovernmentalism" in the EU context, see Moravcsik (1991), Moravcsik (1998), and Sandholtz (1993). Moravcsik (1998) uses a blend of the first and second approaches to analyze monetary integration, pages 238-313. Andrews and Willett (1997) discuss the analysis of international monetary relations both in general and with regard to Europe.

agreement to make concessions on one in return for concessions on the other(s). Thus, one country might "give" monetary union (which it does not favor inherently) in return for "getting" political union (which it does) if the perceived benefits of the latter exceed the costs of the former.[12]

This approach, while appealing, is not unproblematic. For one thing, it is easy to fall into a vague invocation of a link among policy areas without paying careful attention to governments' preferences; for years, journalists and others invoked unspecified "geopolitical" motives to explain bargains among EU members. Any analysis that relies on implicit links must explain how it is we know that these links exist. While many commentators have argued that full participation in the Single Market might be hampered by non-participation in the EMS, for example, there is no provision in the Single European Act or any other EU document explicitly establishing this tie.

Moreover, there is scope for the tradeoffs on which linkage arguments rely only when different nations place different values on different issues. If all EU members placed similar weight (positive or negative) on EMU, there would have been little room for trading off

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[12]Early variants of this analysis spoke of the "spillover" from one area of European integration to another. This was one of the arguments associated with the "neofunctionalist" approach to regional integration, although the approach tended to focus even more on how integration would create or reinforce bureaucratic or social interests in further integration. Moravcsik (1998), Webb (1983), and Keohane and Hoffman (1991) discuss this and other perspectives; an early statement of the approach is Haas (1958).

concessions in different areas, and no room for linked bargaining that might improve the likelihood of agreement.

Finally, effective interstate bargaining requires that governments be able to make credible threats or promises. Otherwise they will fear that their foreign partners will renege on the commitment and refuse to enter into it in the first place. This is more problematic when issues are linked than when bargaining over each issue occurs in isolation, for not only must commitments on each dimension be credible, but the commitment to link dimensions must be credible as well.

Thus, while inter-state bargaining can be important and may involve linkage politics, its use in analysis requires caution and detail. The parties' goals must be specified and analyzed. And given the importance of credibility, particular attention must be paid to how the parties bind themselves to the linkages they create.

2. Domestic Distributional Issues

Just as countries attracted to EMU may bargain with other member states over participation, interest groups that stand to benefit or lose may play an analogous role domestically. While not benefitting a country as a whole, EMU may still enhance the welfare of particular groups, which prevail on their government to support it. EMU, in this view, is just one example of the special-interest politics common to virtually every economic policy arena.

Serious analysis of the distributional implications of EMU is scarce, although there is some suggestive work [such as Giovannini (1993) and Hefeker (1997)]. A few observations are probably uncontroversial. Those for whom currency volatility is most costly stand to gain the most from EMU. They include banks and corporations with pan-EU investment or trade interests: for them forgoing national macroeconomic policy is a price worth paying for the elimination of currency risk. For those for whom cross-border transactions are inconsequential, on the other hand, predictable exchange rates are of little value, while national autonomy in the formulation of macroeconomic policies may be extremely important.

Many of the distributional concerns raised by EMU have had to do not so much with the desirability of a single currency per se as with the more immediate problems of adjusting macroeconomic policy to the requisites of a fixed exchange rate. In a high-inflation country, fixing the exchange rate typically leads to real appreciation, which puts pressure on producers of import-competing goods. This can cause a broad constituency to develop reservations about both fixed exchange rates and monetary union. In the context of EMU, because qualifying for participation required meeting the Maastricht fiscal criteria, those who worried about the impact of budget cuts or tax increases on them tended to resist making these sacrifices.

One implication of many distributional arguments is that support for EMU wiill be shaped by the rise of intra-EU capital mobility and trade. As the EU becomes more financially integrated, the choice between monetary policy autonomy and exchange rate stability becomes increasingly stark. Meanwhile, higher levels of intra-EU trade heighten the importance of exchange rate fluctuations for producers and consumers alike. Meanwhile, increased cross-border investment expands the ranks of those for whom exchange rate fluctuations created problems. Inasmuch as the increased openness of EU economies has involved more economic agents in cross-border economic activity, and these firms and individuals care about reducing exchange-rate volatility, the drive toward the free movement of goods and capital might be expected to have strengthened support for EMU.

Problems with the distributional approach are not so much theoretical as practical. There is almost no empirical work which successfully measures the distributional effects of different international monetary regimes. Even if such work did exist, it would tell us little about outcomes, because interests are mediated by political institutions. Since institutions can magnify the political influence of some groups while diminishing that of others, similar interests may be expressed differently when, for example, parliaments are chosen by proportional representation than when members come from single districts in a first-past-the-post system.[13] Thus, any rounded account of EMU must pay close attention to domestic political factors, specifically to the role of interest groups with strong views on EMU and how they operate within national political institutions.

While additional variables can undoubtedly be brought to bear, the two we have described would appear to be central. We need a clear picture of the interests at stake and the institutional setting within which they are situated. We then need to understand how national

[13]For a summary of such arguments and their application to the area of trade policy, see Rogowski (1987).

governments with divergent goals interact at the EU level, including an exploration of the ways in which EMU is linked to other EU policy areas.

The Political Economy of Monetary Unification in Practice

The domestic distributional effects of international monetary policies have been crucial for European monetary developments. Support for EMU has come from international banks and corporations with an interest in reducing currency volatility and deepening the integration of the European market, and from those in high-inflation countries who saw EMU as a way to achieve German-style monetary conditions. Opposition has come from domestically-oriented economic actors and those who expected to bear the brunt of macroeconomic austerity measures. This includes those in high-inflation countries where a fixed exchange rate and subsequent real appreciation undermined domestic producers' international competitiveness.

In France and Italy in the early 1980s, for example, opposition to policies aimed at sustaining the commitment to a fixed exchange rate came from workers in import-competing industries like steel and transportation equipment. In the early years of the Mitterrand government, France's commitment to the EMS was weakened by the resistance of Communists and left Socialists—whose constituencies were in declining manufacturing sectors hard hit by imports—to the austerity measures needed to bring French inflation down to German levels. A similar dynamic was evident in Italy, where the Communist party and its supporters in the labor movement—again concentrated in import-competing industries like steel -- were reluctant to agree to real wage reductions needed to keep the lira in line with its ERM partners.

The 1992-3 EMS crisis provides another example of how domestic political factors affected monetary integration, in this case by impeding the coordination of members states' macroeconomic policies. The British government might have raised interest rates to defend sterling except that the higher rates would have been passed on by mortgage lenders, and many within the ruling Conservative party worried about the objections of property owners. The Italian government might have enacted drastic fiscal measures to solidify its commitment to low inflation, but this was difficult to achieve over the objections of public employees and others who felt threatened by the prospect of cuts. The French government might have raised interest rates to defend the franc but was reluctant to pursue a policy that ran the risk of raising the country's already high unemployment. The German authorities might have loosened monetary policy in order to reduce pressure on their EMS partners but for the Bundesbank's preoccupation with inflation, which was reinforced by strong domestic anti-inflationary constituencies.

Distributional considerations also help to explain the breadth of the euro zone as it was ultimately established. Once the 1992-1993 crisis was history, a new round of domestic debates began over the desirability of monetary union. It was argued that the single currency was indispensable for maintaining domestic political support for the Single Market. This logic went as follows.[14] The more integrated European economies became, the more pronounced were the distributional consequences of intra-EU currency swings. With the completion of the Single

[14]This argument is elaborated in Eichengreen and Ghironi (1996).

Market, countries that depreciated their currencies would be able to flood other member states with exports – as happened after the southern European devaluations in 1992-1993. Import-competing producers' complaints about opportunistic exchange-rate grew more intense as European integration proceeded. Countries that fail to hold their exchange rates stable, aggrieved import-competing producers insisted, were not good Europeans. They needed to choose, it was said, between getting into the monetary union or getting out of the Single Market. And the Single Market was too significant an economic achievement to placed at risk. Note that the argument here was that the single currency was a necessary concomitant of the Single Market for political economy, not narrowly economic, reasons.

Yet the timing and character of the milestones in European monetary integration remain difficult to explain on the basis of interest-group politics alone. They were almost certainly heavily influenced by inter-state bargaining. For example, it is observed that the Italian government in 1979 was not enthusiastic about the EMS but was presented with a fait accompli by the French and Germans. It is similarly argued that the French government in the 1990s was eager to use EMU to reduce German influence over European monetary policy, while Germany was less ardent in its pursuit of EMU.

The core of the complex bargaining process that has characterized European monetary integration has been the threat or fear that a country refusing to go along with EMU might bear costs on other dimensions of EU policy. In other words, the bargaining relationship involved explicit or implicit links between EMU and other issue areas. Linkages are indeed central to what Garrett (this volume) has in mind when he argues that the German government went along with EMU—which it found unattractive on the merits—in return for assurances that the EU would move forward on political matters, especially a common foreign policy. Martin (this volume) also emphasizes institutionalized linkages. The explanation of French and Italian commitments to the EMS in the early 1980s presented by Frieden (this volume) explores the domestic political impact of such linkage effects. And many analysts have pointed to the connection between the EU's search for exchange rate stability and its Common Agricultural Policy (CAP), the operation of which was severely complicated by fluctuations in EU currency values.[15]

Thus, both domestic politics and inter-state bargaining help us understand why the momentum for EMU was sustained, and why it was not initially sufficient to bring Denmark, Sweden, and the United Kingdom into the fold. Domestic support for monetary unification grew over the course of the 1980s and early 1990s, as continued economic integration created

[15]The CAP is far too complex to explore in detail here. Suffice it to point out that in the context of major agricultural subsidies, the EC sets Community-wide food prices. When a currency is devalued, the EC reference price would normally be raised in the devaluing country to counterbalance the devaluation—thus "passing through" the exchange rate change in full to food prices. The inflationary impact of this pass-through would mitigate the devaluation's attempt to restore price competitiveness in non-agricultural sectors. For this reason, the Community devised a series of compensatory arrangements and accounting exchange rates. For our purposes, what is important is only that exchange rate fluctuations complicate Community agricultural policy by changing compensatory farm payments in ways that could disrupt the delicate balance within the EC on farm policy. For more details see McNamara (1998).

heightened and widened the interest in European-wide markets and policymaking institutions. Some of the effects of the 1992-1994 crisis, such as the impact of "competitive devaluations" on Northern European producers, strengthened the resolve to work for as rapid and encompassing an EMU as possible. Meanwhile, the growing importance of EU-wide decisions on trade, regulation, social policy, and even foreign policy made governments loathe to risk being second-class European citizens. By the same token, it is not surprising that the three countries that are least enthusiastic about European federalism – the United Kingdom, Denmark, and Sweden – balked at the single currency. Domestic political considerations and inter-state bargaining thus worked together to bring Europe's monetary union into being in 1999.

The Future of EMU

What picture do these perspectives paint of the future of EMU? From a narrowly economic viewpoint, high capital mobility, which will undoubtedly be fact of economic life in the 21st century, effectively leaves most countries only the choice between adopting a flexible exchange rate and pegging it once and for all. The growth and articulation of international financial markets, which is ongoing, suggests that countries that cannot live comfortably with a flexible exchange rate -- small countries with open economies highly dependent on international trade and financial flows in particular -- will be attracted by a policy which promises currency stability. Some countries, in Eastern Europe for example, may solve this problem by joining the EU and its monetary union. The implication is that Europe's monetary union will gain a constituency of faithful members who see EMU as a zone of monetary and financial stability and their only viable alternative to the unpalatable option of floating rates.

What of countries like the UK, residents of which are apparently happy to participate in the Single Market, but among whom there remains deep and abiding skepticism about the single currency? A political-economy perspective suggests that this skepticism is rooted in the low level of British commitment to European political integration. For many in the UK, there is a fear that the EU's much-vaunted spillovers and linkages suggest that "one damn thing leads to another" — in this case, that monetary integration will reinforce the movement toward political integration. The decision for the UK may therefore be whether to join Europe's monetary union, and thereby to sign on to the larger project of creating a politically as well as economically integrated Europe, or else to withdraw from the European Union. Given that neither of these options is particularly appealing, one appreciates why the British see themselves as facing a dilemma.

All this assumes that EMU is here to stay. What of the scenario where it falls apart? Feldstein (1997) observes that EU member states with very different preferences are shackled together by a single monetary policy. There is no political union at the outset. National leaders will continue to plump for policies that reflect the differing preferences of their constituencies. Inevitably, some will be disappointed. And since Europeans are unlikely to agree to the extension of large-scale cross-border transfers prior to the creation of a true political union, there is no way of compensating the losers. Disagreement over the stance of monetary policy could then mean serious dispute. Exit, not just voice and loyalty, is one conceivable way for the disaffected to respond.

Technically, exiting the monetary union is straightforward: the government of the participating member state needs only to restart the printing press and reissue the national currency.[16] If a country left the monetary union because it felt that the ECB was following excessively inflationary policies, its "good" domestic currency would drive out the "bad" European currency. If it country instead left because it felt that the ECB's overly restrictive policies were aggravating unemployment, it would in addition have to declare that the euro would no longer be accepted as legal tender within its borders.

But the decision to continue to support or choose to abandon the monetary union will, like its predecessors, be made on political economy, not economic, grounds. The principal inter-state bargaining consideration is that a country that withdraws from the monetary union could face considerable costs in the form of its standing in the EU on other fronts. Just as issue linkage contributed to the establishment of Europe's monetary union, issue linkage stands in the way of its demise. The principal domestic distributional consideration is that support for EMU is in fact substantial in its member countries, and likely to grow over time. Creating a common currency leads to the formation of groups and lobbies with an interest in its persistence. Investments are planned and made, contracts are signed, firms expand and merge, all with the Single Market and

[16]Our discussion of the exit question follows Eichengreen (1998).

the single currency in mind. The economic realities thereby created generate political pressure to maintain the economic policies upon which they were built. As European banks and firms become more European, their stake in the single currency becomes greater, in turn lessening the likelihood that monetary unification will be reversed subsequently.

About This Volume

The contributors to this volume analyze European monetary integration from both the political and economic points of view. The first chapter, by Jeffry Frieden, considers the experiences of France and Italy in the early years of the EMS. Frieden argues that two factors were central to the politics of exchange-rate policy in these countries. First were the distributional effects expected to result from binding the franc and the lira to the EMS. Import-competing manufacturing sectors opposed fixing exchange rates in ways that would erode their ability to compete with foreign producers, while internationally oriented sectors favored currency stability. Second was the linkage constructed between the EMS and the other aspects of European integration. This forced interest groups in both countries that were ambivalent or hostile to the EMS to weigh these concerns against their general attitude toward the EU, and in many cases to go along with monetary policies that they otherwise might have tried to block.

The second chapter, by Matthew Gabel, investigates the domestic political bases of support for EMU in more detail. Gabel considers how socio-economic status affects sentiment toward monetary union. He confirms that members of socio-economic groups that expected to gain most from the reduction in currency volatility and the removal of barriers to cross-border trade and finance tended to be most enthusiastic.

Even if special interests are important, it would still be puzzling that domestic political support for EMU was so strong if, as much economic analysis has insisted, monetary union has few economic benefits in and of itself. In his chapter, Charles Engel presents evidence that monetary unification might not entail the economic sacrifices many expect. He shows that local prices have not responded quickly to exchange rate movements, which means that the exchange rate has not been an effective tool of macroeconomic policy. To the extent that local-currency pricing mitigates the ability of currency policy to affect national economies, giving up an independent currency may involve fewer costs than is usually anticipated.

The next pair of chapters, by Geoffrey Garrett and Lisa Martin, examine how inter-state bargaining made EMU possible and affects its future. Garrett analyzes the Maastricht Treaty as a bargain between Germany, a country standing to gain little from monetary union per se, and the rest of Europe. EMU must be understood, he argues, as a trade across issue areas. Germany made significant concessions on matters monetary, according to Garrett, in return for general European support for German unification, as well as for a deepening of trade and investment ties with the rest of the EC.

Martin insists that the EMU debate be viewed as embedded in an institutionalized pattern of inter-state cooperation. The same set of countries is engaged in negotiations over defense, social policy, competition policy and, of course, monetary policy, and the way those negotiations are structured and institutionalized means that failure to reach agreement on one issue places agreement on the others at risk. The fact that countries stand to lose all the gains they have made from cooperation on a variety of issues has thus tended to lock in agreement on monetary matters.

The role of these institutional arrangements is key, Martin argues, to understanding the outcomes thereby achieved. For example, the disproportionate influence of small states in the governance of the monetary union must be understood as a function of formal decision-making procedures such as unanimity requirements used to solidify cross-issue links.

In the next chapter, Paul DeGrauwe, Hans Dewachter, and Yunus Aksoy provide a detailed analysis of one such arrangement: the decision-making structure of the European Central Bank. They show how the monetary policy of the ECB will depend on the structure of EMU institutions and on whether the members of the ECB board remain primarily national in orientation or develop a more pan-European perspective. Only if a more European view prevails, they argue, will EMU improve conditions in the Euro area.

Their analysis, like most of the literature, takes for granted that monetary union is irreversible. The final chapter, by Benjamin Cohen, challenges this assumption. Contrasting the experience of three surviving monetary unions (the CFA Franc Zone, the East Caribbean Currency Area, and the Common Monetary Area) with three that failed (the East African Community, the Latin Union and the Scandinavian Union), Cohen asks whether economic, political or organizational factors explain success or failure. He concludes that appropriate economic conditions (high factor mobility, symmetric shocks) and organizational structures (an independent central bank, legal provisions for currency issue) have not always been sufficient to hold a monetary union together; rather, political factors broadly defined are key. The presence or absence of a dominant power or sufficient political cohesion are needed to sustain monetary union over time.

Conclusions

The essays in this volume testify to the complexity of Economic and Monetary Union in Europe and to the need for an integrated political economy approach to understanding it. Macroeconomic analyses help clarify the economic costs and benefits of monetary integration. The benefits include reductions in transactions costs and in the uncertainty associated with cross-border trade and payments. The costs are principally due to the loss of a policy instrument with which to respond to unexpected shocks. Political analyses point to the role of domestic interests and to institutionalized relationships among EU member states. The distributional concerns of interest groups have powerful effects on the political constraints facing national governments and monetary policymakers. But these effects operate within an environment of ongoing negotiation among the European governments engaged in the search for mutually acceptable agreements on the road to broader and deeper integration.

These economic and political factors will continue to be central to the evolution of Europe's economic and monetary union. They will determine its membership – whether any current members leave the Union, which of the four EU member states that are not in EMU join it, and whether candidate members in Central and Eastern Europe abandon their currencies for the euro. They will have a powerful impact on the policy of the European Central Bank as it establishes itself as the monetary authority for Europe and as one of the world's three principal central banks. For all these reasons, the political economy perspectives presented here help explain the past and understand the future of European monetary integration.

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