On the Links Between Monetary and Political Integration

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The connection between monetary integration and political integration is probably the most contentious aspect of the Maastricht process. There exist three positions on this question. The first is that monetary unification necessarily entails political integration. This argument is advanced by those who believe that a stronger European Parliament is needed to hold the European Central Bank (ECB) accountable and encourage the development of a common fiscal policy at the EU level. A second view is that political integration necessarily entails monetary integration. This is the position held by proponents of the "bicycle theory" -- by those who believe that European integration has always been and continues even now to be driven by functionalist spillovers, in this case from the monetary to the political domain. It is the conclusion of those who see the single currency as signalling the irreversibility of the European project and providing a powerful identify symbol (Issing, 1996). The third position is that there is no intrinsic connection between monetary and political integration; this is the opinion of British politicians and Eurosceptics generally.

My purpose in this paper is to argue a fourth point of view. I suggest that relationship between monetary and political integration is contingent; under only slightly different initial conditions, these two dimensions of the integration process can evolve in very different ways. Specifically, whether

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monetary and political integration develop hand in hand or the first progresses without significant movement toward the second will depend on the accompanying fiscal constitution. If the fiscal freedom of participants is constrained, there will be pressure for monetary union to be accompanied by political union. But if EMU members are free to formulate their own national fiscal policies, monetary unification will generate little pressure for political integration. In technical terms, the link between monetary and political union has a path-dependent character, with the final outcome sensitive to small variations in initial conditions. This suggests that the prospects for political integration in Europe will turn on some technical but in fact momentous decisions about fiscal policy to be taken in the not-too-distant future.

My perspective on the nexus between monetary and political integration has some points of overlap with what I have called the three conventional positions on the issue, in particular the first two. It admits the existence of pressure for political integration to render economic policy makers accountable, but it suggests that the need for accountability is even greater in the fiscal than the monetary context. It admits the existence of functionalist spillovers, from the Single Market to monetary union and, depending on the specifics of accompanying fiscal arrangements, from the monetary to the fiscal and political domains. But it differs from these previous views in regarding the connections between monetary and political integration as contingent -- that is, as a path-dependent process which leads to radically different outcomes depending on some small changes in initial, fiscal, conditions.

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The one previous position with which my analysis has no overlap is the British, or Euroskeptic, view that there is no intrinsic connection between monetary and political integration. The literature features two standard counter-arguments. One is that EMU and the Single Market project are linked by political factors. In light of the progress made since the adoption of the

Single European Act, the principal remaining threat to the creation of a truly free and integrated internal market is political opposition from sectoral interests that suffer disproportionately from exchange rate swings. This is the "competitive devaluation problem," in which producers who experience increased import competition as a result of currency depreciation abroad run to their national capitals for state aids and subsidies. According to this argument, the creation of a true Single Market free of barriers to intra-EU competition requires monetary integration now that the elimination of capital controls has undermined the ability of governments to peg exchange rates within narrow bands and prevent arbitrary misalignments.

For many of those who see national politics as the channel through which inadequate monetary cohesion threatens the operation of the Single Market, political integration is the corresponding solution. French machine tool producers may be well placed to extract subsidies from Paris in the event of a depreciation of the lira that enhances the competitive position of their Italian rivals, given years of cultivating the requisite political access, but they are considerably less well placed to obtain such aid from Brussels and Strasbourg, where their Italian competitors, and more generally other interest groups for whom the exchange rate instrument cuts the other way, provide an effective counterweight.

The second conventional link between monetary and political union runs through Germany's desire for an increased geopolitical role. According to this argument, Germany has little intrinsic interest in monetary union, since the Bundesbank already controls the stance of monetary policy over much of Europe. For historical reasons, however, Germany is unable to project foreign-policy influence abroad. It is therefore willing to concede EMU, which France and other countries need in order to regain some control over their monetary destinies, in return for an EU foreign policy, under whose cover Bonn and Berlin can exercise an enhanced foreign-policy influence. And political integration is a prerequisite for the creation of a meaningful EU foreign policy. The latter requires empowering the EU to deploy the troops of its member states. It implies depriving governments of the right to veto such action. It means nothing less than significant political integration.

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Both of these arguments positing a link between monetary and political integration are distinct from the assertion that monetary unification necessarily entails political integration to render the European Central Bank democratically accountable (a variant of the first of the three conventional arguments above). In this view, the ECB, like any central bank, needs the independence to choose its operating tactics but must nonetheless be accountable to Europe's citizens and elected representatives, who are ultimately entitled to determine its policy strategies and goals. In the United States, this accountability is provided by Congressional oversight. Whenever significant segments of the American public object to the policies of the Fed, the chairman of the Federal Reserve Board and the presidents of the regional reserve banks are called up to Capitol Hill to testify under the hot klieg lights of the House Banking Committee. The ultimate sanction of U.S. politicians is the threat of a bill compromising the independence of the Fed.

In the absence of political integration in Europe, the ECB would face no comparable sanction. The European Parliament possesses only limited responsibilities. The statute of the ECB, which guarantees its independence, is embedded in an international treaty that could only be modified with the agreement of all 15 signatories, a fact which poses a formidable obstacle to change. Significantly strengthening the European Parliament is necessary if the latter is to assume such powers and to hold the ECB politically accountable.

The flaw in this argument is the assumption that democratic accountability, to use the standard Weberian terminology, is the only grounds on which Europe's citizens are prepared to regard the ECB as legitimate. This flies in the face of the fact that countries the world over are strengthening the statutory independence of their central banks -- that is, they are making it harder and harder for politicians to compromise the independence of the monetary policy making process. They are weakening the democratic accountability of their central banks, not strengthening it. Given the importance financial markets attach to policy credibility, politicians and their constituents are increasingly willing to delegate the conduct of monetary policy to independent experts. They are prepared to evaluate the conduct of monetary policy in terms of longer-term performance instead of short-term responsiveness to political pressures.

Weber himself recognized technical efficiency as a source of political legitimacy (Weber, 1984 edition). He suggested that princes and patriarchs providing efficient governance might be regarded as legitimate even in the absence of democratic accountability. Increasingly it seems that this is the case of central banks.

Thus, I would argue that monetary integration and political integration in Europe are connected but that the mechanisms are not those emphasized in the literature on the democratic accountability of the European Central Bank. The links run rather through the political threat to the Single Market posed by separate sovereign monetary policies and through Germany's foreign-policy aspirations.

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If we accept these linkage arguments and assume that EMU will proceed, the question becomes how quickly political integration will follow, if at all. My hypothesis is that political integration will follow quickly if monetary integration entails significant fiscal centralization, but slowly if at all otherwise. Fiscal functions, and specifically taxation, are the core of what we mean by political sovereignty. The power to tax is essential to both domestic and international security. Thus, transferring key fiscal functions from member states to the EU will limit the capacity of the former to carry out the responsibilities of sovereign political entities and create an entity with that capacity at the level of the Union. Political integration will follow.

Moreover, the need for a strong political body at the level of the Union will be essential to render those who formulate the common fiscal policy politically accountable. The need for political accountability is stronger in the context of fiscal than monetary policy, for two reasons. First, fiscal policy's distributional aspect is more prominent. Interest rate changes are not without distributional consequences, but the impact on the distribution of income and wealth is infinitely more pronounced in the case of taxes and public spending. Second, the track record of superior policy performance accumulated by independent central banks over the years will not reside in the EU's nascent fiscal authority. Technical arguments for an independent policy authority to overcome time inconsistency problems are less compelling in the fiscal than the monetary case. Weberian technical efficiency as a substitute for democratic accountability is less well established in the fiscal context.

Initially, the fiscal functions of EU member states will grow in importance with the advent of EMU. Among these are the ability to borrow to damp macroeconomic shocks (to operate automatic stabilizers), the capacity to provide regional coinsurance (to establish a system of fiscal federalism), and the power to borrow for public investment purposes (that is, for the provision of public goods). Automatic fiscal stabilizers will become more important when recourse to an independent monetary policy is lost. Fiscal transfers will be valued more when the exchange rate is no longer available to offset idiosyncratic shocks.

How quickly European monetary integration leads to European political integration will thus depend on whether national governments are significantly restrained in their pursuit of these fiscal goals by the structure of the monetary union. Pressure for political integration will depend on the stringency of enforcement of the Excessive Deficit Procedure of the Maastricht Treaty and the design of any concomitant Stability Pact. Measures that prevent national governments from executing their core fiscal functions will create pressure for Brussels to execute those functions for them.

Tight enforcement of the Excessive Deficit Procedure, especially in the early years of Stage III, would prevent the member states' automatic stabilizers from operating. It seems likely that most founding members of the monetary union will enter Stage III up against the three per cent limit on budget deficits; if so, they will be forced to increase taxes and cut public spending in the first post-EMU recession to keep from violating the deficit ceiling. Prohibited from borrowing to permit the operation of their automatic fiscal stabilizers, they will pressure the EU to borrow for them to prevent a dangerously procyclical fiscal policy from destabilizing the European economy. Tight enforcement of the Excessive Deficit Procedure will prevent government from borrowing for public-investment purposes. To keep this constraint from forcing them to forego competitiveness-enhancing investments in education and infrastructure, they will again pressure the EU to borrow for them. And deprived of both monetary and fiscal instruments for dealing with asymmetric shocks that affect some national economies more strongly than others, they will press for the development of a system of fiscal federalism at the EU level.

Thus, whether monetary unification creates strong pressure for the transfer of budgetary functions to Brussels and for strengthening the European Parliament as a way of providing governance for this expanded EU fiscal policy will depend on the stringency with which the Excessive Deficit Procedure and Stability Pact are enforced. Journalistic accounts typically suggest that German Finance Minister Theo Waigel and the Bundesbank are skeptical or even downright hostile to monetary union but that their objections have been overridden by Chancellor Kohl, who sees himself as the last Chancellor representing the postwar generation and therefore as responsible for locking Germany into Europe politically. While the Chancellor wants EMU because he so values the political integration that Germany will get in return, Waigel and Bundesbank officials do not share his conviction and insist on strict application of the convergence criteria to minimize the likelihood of an outcome they regard as undesirable.

The perspective developed here suggests that Herr Waigel, Bundesbank officials and Chancellor Kohl are working together in harness, not pulling in opposite directions. By insisting on vigorous application of the Excessive Deficit Procedure and a strict stability pact, Waigel and the Bundesbank will in fact maximize the speed with which European integrates politically, thereby achieving Kohl's ultimate goal. Whether they are conscious of their confluence of interests is difficult for an outsider to say. At a minimum, one can infer that the Chancellor tolerates -- perhaps encourages -- the insistence of Waigel and the Bundesbank on a strong stability pact because he realizes that transferring oversight of national fiscal functions to the EU will accelerate movement toward his goal of political integration.

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If limits on the fiscal freedom of national governments were indispensable for the smooth functioning of a monetary union, political integration would follow EMU as a matter of course. Monetary integration would involve fiscal restrictions, and fiscal restrictions would lead to the centralization of fiscal functions in Brussels, prompting the move to political union.

From a narrowly economic perspective, the need for fiscal restrictions in a monetary union is a dubious proposition. One argument for fiscal restrictions is to prevent member states from overborrowing and driving up the level of interest rates Europe wide. However, this argument is independent of monetary union (it is an implication of integrated capital markets, not of a single currency). It overlooks the fact that Europe is but part of a larger global capital market. The argument that the Italian government could increase the cost of borrowing for German households and firms loses its force when it is recognized that Europe's governments, households and firms borrow on global capital markets.

Another argument for fiscal restrictions is to encourage policy coordination among member states. However commendable the goal, it can be plausibly argued that strict limits on deficit spending by EMU member states are more of an obstacle than an aid to achieving it. The Maastricht Treaty acknowledges this by specifying another article quite separate from the Excessive Deficit Procedure, the so-called Mutual Surveillance Procedure, to facilitate policy coordination in Stage III.

A final argument for fiscal restrictions is to insulate the ECB from pressure to come to the aid of national governments that encounter debt-servicing difficulties. Governments experiencing difficulties in servicing their debts will press the ECB to keep interest rates artificially low. They will implore it to purchase their securities if investors lose confidence in their credit worthiness and refuse to roll over maturing issues. Both responses could impart an inflationary bias to Europe's monetary policy.

The problem with this argument is that the Maastricht Treaty also includes a quite separate no-bailout rule which prohibits the ECB from purchasing government securities directly from the issuer or otherwise assisting a government in fiscal difficulties in ways that might jeopardize price stability. There is every reason to think that this prohibition will stick so long as national governments control their own fiscal functions. If they continue to raise the bulk of Europe's taxes and administer the majority of its spending programs, they will retain the leeway to raise revenues and cut spending in any fiscal crisis. They will have the capacity to reassure the markets that they are prepared to put their fiscal affairs back on track.

Only if tax instruments and spending programs are centralized at the level of the EU will national governments lack the fiscal flexibility to respond to problems they experience in servicing their inherited debts. Say that corporate and personal income taxes are turned over to the EU, leaving only user fees for a limited range of public services in the control of national governments. If the demand for those services falls off, depressing the associated revenues, there may be little those governments can do. Their only options will be default and a bailout from EU authorities; lobbying for a bailout, and pressure for a positive EU response, will be correspondingly intense.

Thus, restrictions on the fiscal autonomy of the members of a monetary union are not essential. This points to the possibility of two very different equilibria in post-EMU Europe: one in which fiscal restrictions are tightly enforced and progress toward political integration is swift; and another in which the enforcement of fiscal restrictions is lax and monetary union does little to accelerate the momentum toward political integration. Both equilibria are feasible and stable, and Europe can arrive at either one.

To which one the EU gravitates will depend on the decision of what kind of fiscal restrictions to place on national governments. Early bargaining appears to have ruled out the extreme positions -- both Germany's demand for a Stability Pact with rules, fines, and no exceptions and other member states' preference to leave the Excessive Deficit Procedure as is. The likely outcome at the Dublin Summit is a compromise, a Stability Pact looser than Germany prefers but tighter than would satisfy the taste of most other member states. Here, as often is the case with the EU, the proof of the pudding will be in the tasting. The vigor with which those fiscal provisions are enforced will determine whether the EU settles into the low- or high-political-integration equilibrium.

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