A Stronger Union Through Crisis? 25 Years of Monetary Integration in Europe

By Ferdinand Fichtner and Philipp König

On July 1, 1990, when capital controls in the European Economic Community were removed, the path was paved for the introduction of the euro. This path was marked by a compromise between two schools of thought—those who assumed that the creation of the European Central Bank would be followed by greater economic convergence and political integration, and those who saw the single currency as the coronation of European cooperation and economic convergence. In the initial years following the introduction of the single currency, the compromise as set down in the Maastricht Treaty—the speedy introduction of the single currency, on the one hand, and better cooperation in fiscal policy matters on the other—neither strengthened the institutional foundations of the monetary union nor advanced the political integration process. This resulted in economic divergence and tension in the euro area, which in recent years culminated in a severe crisis. It was only in response to this crisis that some of the necessary changes to the institutional structures of the monetary union were made. There is much evidence to suggest that, when the monetary union was originally being created, such tension and even crisis situations were consciously tolerated because of the stimulus for deeper integration this would provide. Such political maneuvering is very risky, however, since it can lead to the loss of public support for the integration process, thereby threatening the very existence of the common currency. To advance the European project, it is imperative that governments do not rely on the momentum inherent in crisis situations, but instead press ahead with the next stages of integration and take an active approach to bolstering the institutional foundations of the currency union.

The removal of capital controls between the member states of the European Economic Community on July 1, 1990 marked the beginning of what is probably the most ambitious monetary policy experiment in recent history—the introduction of a single currency in Europe.

The basis for the abolition of capital controls (see Table) was the implementation of the Single European Act, which had come into force three years previously; besides the removal of capital controls, the Single European Act also set down the creation of a European Single Market and the objective of an economic and currency union was reaffirmed by the signatory member states.[1]

At the European Council summit in June 1988 in Hanover, this goal was fleshed out and a dedicated committee assigned the preliminary work under the auspices of the then President of the European Commission, Jacques Delors. The report presented by Jacques Delors the following year proposed a single European currency be introduced in three successive stages, beginning on July 1, 1990 at the latest, concurrent with the removal of capital controls. A resolution passed by the European Council at its summit in Strasbourg in December 1989 ultimately confirmed the commencement of the three-stage process on the date proposed in the Delors Report.

First Steps on the Road to Monetary Union

As early as in 1970, a commission chaired by Luxembourg premier Pierre Werner presented the first proposal for the creation of an economic and monetary union.[2] Known as the Werner Plan, this proposal included a road map for the creation of a monetary union over a period of ten years. It comprised a three-stage design for closer cooperation on economic policy matters, the

1 These were Belgium, Denmark, Germany, Greece, Spain, France, Ireland, Italy, Luxemburg, the Netherlands, Portugal, and the United Kingdom.

2 P. Werner, "Report to the Council of the Commission on the Realisation by Stages of Economic and Monetary Union in the Community," *Bulletin of the European Communities*, Supplement 11 (1970): 1–65.

Table

Capital Controls in ERM Depending on Types of Transactions
Year: 1988

	Securities		Loans		Other Transactions	
	Primary Market	Secondary Market	Trade Credit	Other	Deposits	Other
Belgium	K/A	K	K	K	K	K
Danmark	K	K	A	A	A	A
France	R/A	K	R	R	K/R	K
Germany	K	K	K	K	K	K
Ireland	A	K/R	K/A	K/A	K/U	K/U
Italy	A/U	K/R	K/A	K/A	K/U	K/U
Luxemburg	K/A	K	K	K	K	K
Netherlands	K	K	K	K	K	K
United Kingdom	K	K	K	K	K	K
Greece	A/U	A/U	A	A	R/U	R/U
Portugal	R/A	R/A	A	A	A	A
Spain	A	K/R	A	R/A	K/A	A

First letter refers to capital inflows, second letter to capital outflows; if only one letter is shown it refers to both in- and outflows.
K = no controls
A = authorization required
R = resreicted (for example with respect to maturity, use, volume)
U = prohibited (or required authorization that was usually not granted).

Source: Eichengreen, B. und Wyplosz, C. (1997): a.a.O., 159. Originalquelle: Morgan Guaranty Trust Co. (1988): Financial Markets in Europe Toward 1992. World Financial Markets 5, 5.

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liberalization of capital movements, and measures to combat structural differences between the participating countries. Despite the strong initial support that it enjoyed in Germany and France, the Werner Plan was soon shelved. Given the currency turmoil following the collapse of the Bretton Woods system and the resultant floating of exchange rates in Germany and the Netherlands, it is very likely that, in the early 1970s, the political will and scope required to irrevocably commit to a monetary union would have been lacking.[3]

The mid-1980s saw a turn of events. The decision to create a common agricultural policy lent the European integration process new momentum. In 1986, increasing integration at institutional level, ever-stronger trade links between member states, and the pending expansion of the European Community through the accession of Spain and Portugal finally culminated in the ratification of the Single European Act (SEA).[4]

The removal of capital controls set down in the SEA immediately elicited the question of a reform of European monetary and exchange rate policy. In 1979, on the initiative of Helmut Schmidt and Valéry Giscard D'Estaing, the European Monetary System (EMS) had been created, obligating participating countries to keep exchange rate fluctuations within fixed bandwidths. Since individual national monetary policies continued to be autonomous, the free movement of capital was not compatible with this arrangement.[5]

In addition, the EMS had regressed into a "deutschmark block" of sorts, where the other members felt forced to follow the stability-oriented policy of the German *Bundesbank* or to depreciate their currencies against the German mark.[6] As a result, the feeling of disgruntlement toward Germany and the monetary policy of the German *Bundesbank* had continued to grow steadily following the creation of the EMS.[7] In 1987, this led French Treasury Secretary Édouard Balladur, seconded

3 See O. Issing, *The Birth of the Euro* (Cambridge University Press, 2008), 5; W. Buiter, G. Corsetti, and P. Pesenti, *Financial Markets and European Monetary Cooperation – The Lessons of the 1992–93 Exchange Rate Mechanism Crisis* (Cambridge University Press, 1998), 22.

4 B. Eichengreen, *The European Economy since 1945 – Coordinated Capitalism and Beyond* (Princeton University Press, 2007), 336.

5 R. Mundell, "Capital mobility and stabilization policy under fixed and flexible exchange rates," *Canadian Journal of Economic and Political Science*, vol. 29 (1962): 475–485.

6 Issing, *Birth of the Euro*, 7.

7 H. James, *The Making of the European Monetary Union* (The Belknap Press of Harvard University Press, 2012), 227.

by Italian counterpart Giuliano Amato, to call for the creation of a new, less asymmetric monetary policy arrangement.[8] The essence of the Franco-Italian criticism was that the restrictive monetary policy pursued by the German *Bundesbank* was, judged by economic conditions in many other EMS member states, too restrictive. To defend the fixed exchange rate, weaker countries were thus forced to follow an–from their perspective–inappropriately restrictive monetary policy.

Free capital movements threatened to exacerbate this asymmetry. Without the option of capital controls, weaker countries could only attempt to put a stop to speculative capital flows by raising interest rates.[9] The less support from the German *Bundesbank* as guardian of the "anchor currency" in the EMS, the more expensive this was in real economic terms.

The creation of a Single Market as part of the Single European Act brought the removal of capital controls in its wake; but it unleashed economic centrifugal forces that required the reorganization of European monetary and currency arrangements.

Single Currency: Locomotive for Integration or Coronation of Long-Term Integration Process?

The debate on monetary matters in Europe was characterized by two opposing schools of thought. Those representing the so-called monetarist position,[10] often expressed in French circles, assumed that the creation of a monetary union would provide stimulus for deeper economic integration and would automatically result in precisely that (locomotive theory). Diametrically opposed was the so-called economistic position—one that was rather prominent in Germany, for example—that economic structure and economic performance have to converge first; this process may be accompanied by institutional changes and can ultimately lead to a monetary union (coronation theory).[11]

In January 1988, in response to the Franco-Italian criticism of the EMS, German Foreign Minster Genscher issued a "Memorandum for the Creation of a European Currency Area and a European Central Bank."[12] On the one hand, the memorandum constituted a break with the previous German standpoints in currency matters. Leaving behind a strictly economistic course, Genscher moved towards the monetarist position by accepting that economic convergence and monetary integration *can* happen concurrently.[13] In doing so, Genscher was taking the initiative to carry out the much-needed reform of the European currency system, but at the same time representing Germany's position on the all-important issues of the day. In fact, Genscher's memorandum underlined the need for economic convergence between member states, and the proposals made on the institutional structure of a European central bank were likewise based on principles which were rather German in nature, for instance, political independence and the primacy of price stability.[14]

The Delors Commission appointed in June 1988 took up this compromise line in their report:[15] on the one hand, the report issued a clear stability-oriented mandate and outlined the political independence of the new central bank, emphasizing the need for an absolute minimum of economic convergence prior to introducing the new currency. On the other hand, the commission called for the speedy establishment of a new European system of central banks and a European central bank in the second phase of the transition to the monetary union.[16]

During this transitionary phase, however, the compromise between monetarist and economistic thinking caused all sorts of difficulties. In December 1991, the Maastricht Treaty, which set forth criteria for the intended pre-monetary-union economic convergence and defined a fixed timetable for the introduction of the monetary union, was ratified: after the removal of capital controls in the first stage of the process, the second stage—which included the establishment of the European Monetary Institute (EMI) as a precursor to the ECB—was set to begin on January 1, 1994; the third stage— the final and irrevocable fixation of exchange rates and the introduction of the single currency—was to have been completed by January 1, 1999 at the latest.

8 E. Balladur, Memorandum by Edouard Balladur to the ECOFIN Council (1988); translated for the European Commission Monetary Committee.

9 Foreign currency reserves, the alternative means to intervene, were by no means sufficient to counter the speculative capital that could be moved on the financial markets.

10 This must not be confused with the economistic position of "monetarism" which was largely characterized by the works of Milton Friedman.

11 Buiter et al., *Financial Markets*, 32; Issing, *Birth of the Euro*, 6.

12 Eichengreen, *European Economy*, 351; European Parliament, "Der lange Weg zum Euro," *CARDOC (European Parliament Archives & Documentation Centre),* no. 8 (February 2012): 56.

13 S. Schieder, "Liberalismus vs. Realismus: Der Versuch einer Einordnung des "Genscherismus" in die Theorie der internationalen Beziehungen," in *Hans-Dietrich Genschers Außenpolitik*, eds. K. Brauckhoff and I. Schaetzer (Springer VS, 2015), 41–66.

14 James, *European Monetary Union*, 229.

15 Eichengreen, *European Economy*, 352.

16 Buiter et al., *Financial Markets*, 29. See James, *European Monetary Union*, for a detailed discussion on the eight Delors Commission sessions.

In the event of delays in the convergence process, this tight schedule barely left enough leeway to make viable adjustments. Given that it was the responsibility of the heads of state and government to monitor compliance with the criteria, the mandatory economic convergence conceded to the economistic position took on a political dimension, too; much suggests that deviations from the path of convergence by key member states would have been tolerated.[17,18]

At the same time, free capital movement was a *fait accompli* which, in conjunction with the fixed convergence criteria as per the Maastricht Treaty, made the European currency structure susceptible to speculative attacks during the transitionary second stage of the monetary unification process.[19] The –in particular in case of unfavorable economic conditions and existing structural differences between the countries– fragility of this arrangement became apparent during 1992 and 1993.

The 1991 recession had brought about a rise in unemployment, which was already at a high level in Europe. This increased the real economic costs of the restrictive monetary and fiscal policy measures which were required to meet the convergence criteria. At the same time, the German *Bundesbank* had inflationary pressures resulting from reunification to contend with; since 1991, the *Bundesbank* had been gradually increasing its interest rates with no regard for the impact this had on the common exchange rate mechanism. Faced with ever increasing interest rates in Germany, the other countries involved also had to raise interest rates to avoid excessive capital outflows, making their economic problems even worse.

In a referendum held in 1992, the Danish population voted against the Maastricht Treaty and subsequently the French government announced they would also be holding a referendum. This shattered the expectations placed in the irreversibility of the monetary integration. If the French had also rejected the Maastricht Treaty, this would have put a definitive end to the single currency.[20]

Given this possibility, the acute real economic cost of the "convergence policy" was suddenly of considerable consequence, thus increasing the vulnerability to speculative attacks. Faced with concerted speculative attacks, countries such as Italy or the United Kingdom, whose currencies were overvalued, were consequently more likely to devalue their currency, and leave the European exchange rate mechanism. Indeed, from the summer of 1992 on, the financial markets were increasingly putting their bets, among others,[21] on a devaluation of the Italian lira and the British pound. As a result, both countries initially had to leave the exchange rate mechanism and the United Kingdom even turned away from membership of the single currency.[22] This currency turmoil was not fully over until July 1993, when the bandwidths for exchange rate fluctuations were substantially widened.

Hence, the transition period conceded to the economistic school of thought was extremely fragile and even threatened to end in the failure of the entire monetary union project.

Europe—an Optimum Currency Area?

In view of the imminent introduction of the single currency, optimum currency area theory (OCA theory) experienced a renaissance in academic and policy-oriented publications.[23] A number of studies were conducted to examine whether the economies of the member states of the (future) European monetary union had experienced asymmetric effects (shocks) and, if so, wheth-

17 A particularly impressive example of the inherent political dimension of the convergence criteria is the following statement by former German Chancellor Helmut Schmidt. In the 46th edition of the German weekly *Die Zeit* of November 8, 1996, Helmut Schmidt writes an open letter to the then President of the German Central Bank Hans Tietmeyer, who repeatedly insisted that the convergence criteria be strictly complied with: "What you fail to mention is Article 104c, which was added to the EC Treaty as a result of the Maastricht Treaty, and the broad scope for decision-making that this affords the European Council—outwith any criteria whatsoever. Rather, you persist in giving the inaccurate impression that the criteria laid out in the Maastricht Treaty protocols are absolutely binding. However, since the ratification of the Maastricht Treaty, the EC Treaty now states: 'If a member state meets just one or none of these criteria, all other relevant factors shall be taken into account, including the medium-term economic and budgetary situation in the said member state.' [...] I can openly admit: I, too, wish for a high degree of convergence among the national economies of the member states. Convergence is not, however, crucial for the euro to work."

18 See L. Bini-Smaghi, T. Padoa-Schioppa, and F. Papadia, "The Transition to EMU in the Maastricht Treaty," *Princeton Essays in International Finance* (1994): 194.

19 This applies in particular to the requirement to keep the exchange rate stable for a period of two years in order to proceed to the third stage. If a country were forced into depreciation once, however, it would be debatable whether it would be willing to take on board the costs of a restrictive monetary and fiscal policy for a further two years in order to be able to qualify for membership to the single currency. If not, this would justify the *ex post facto* attacks. For more on this, see B. Eichengreen and C. Wyplosz, "The Unstable EMS," in *European Monetary Unification – Theory, Practice and Analysis*, ed. B. Eichengreen (MIT University Press, 1997), 153–224; Buiter et al., *Financial Markets*.; B. Eichengreen, "Epilogue: Inconsistent Quartets," in *European Monetary Unification – Theory, Practice and Analysis*, ed. B. Eichengreen (MIT University Press, 1997), 323–328.

20 On September 20, 1992, the French population voted for the adoption of the Treaty, albeit by an extremely tight majority of 51.1 percent, which was not enough to stabilize trust in the markets as an immediate consequence.

21 There were also strong speculations against the Swedish krona, the Finnish markka, the Spanish peseta, the Portuguese escudo, and the French franc.

22 For a more detailed description of the British pound crisis and the EMS crisis in 1992/93, see Eichengreen and Wyplosz, "Unstable EMS"; Buiter et al., *Financial Markets*; B. Eichengreen, *Globalizing Capital – A History of the International Monetary System* (Princeton University Press, 2004).

23 A brief overview on the theory of optimum currency areas can be found in A. Belke, K. Bernoth, and F. Fichtner, "The Future of the International Monetary System," *DIW Economic Bulletin*, no. 37 (2011): Box 2, p. 15.

er the adjustment mechanisms in place—in particular high factor mobility between the countries—had been effective enough to offset the absence of an independent monetary and exchange rate policy.

Following a detailed cost/benefit analysis and in due consideration of the criteria derived from OCA theory, an extensive study by the European Commission conducted in October 1990 found that the creation of a European monetary union could be expected to result in microeconomic efficiency gains (e.g., as a result of the removal of transaction costs) and greater macroeconomic stability (with regard to inflation, production, and employment).[24] One of the arguments presented was that, given the very diversified economic structures of the European economies, individual countries were relatively immune to sector-specific shocks, which is why those had very little effect on macroeconomic developments. In addition, the high degree of capital market integration in the European Economic Area (EEA) was considered an important factor in favor of the creation of a monetary union.[25] Moreover, the integration on the goods and factor markets that a monetary union would bring about tends to go hand in hand with increasing business cycle synchronization, which in turn means lower costs for the relinquishment of country-specific monetary policy.[26]

By way of contrast, a number of other studies, e.g., those based on comparisons with the US, concluded that countries in the European Community were more prone to asymmetric shocks than other areas of economic integration.[27] According to such studies, mobility, in particular with regard to labor, lagged far behind that of other regions.[28] Other studies criticized the level of financial policy integration in the European Community, saying it lagged far behind the US, which is why it is of limited use in correcting any economic divergence in the monetary union, should that occur.[29]

Overall, when it came to the suitability of the European Economic Area for monetary integration and the road map outlined in the Maastricht Treaty, experts were rather skeptical. Such concerns, however, had very little impact on the actions taken by the key political decision-makers; with the exception of the exit of the United Kingdom in 1992, the road map laid out in the Maastricht Treaty was implemented according to plan. In this way, the introduction of the single currency demonstrated the dominance of the monetarist position:[30] instead of creating the economic policy and institutional conditions for a European fiscal and monetary union before actually establishing the monetary union, the single currency was introduced in the good faith that it would become the key driving force behind ever deeper integration.

Jacques Rueff, French economist and later adviser to Charles de Gaulles, is reported to have said as early as 1949: "L'Europe se fera par la monnaie ou ne se fera pas"—Europe will be created by means of a single currency or not at all. Half a century later, Otmar Issing, Chief Economist of the European Central Bank, stated: "With the onset of Monetary Union the Maastricht Treaty has created a unique, historical asymmetry. On the one hand, a European, supranational monetary order, yet predominantly national sovereignty in most other areas. This combination creates a tension that will leave its mark on the future integration process. There can be no turning back, as the failure of Monetary Union would not only be extremely costly from an economic point of view, but the political fallout would be unimaginable and would be tantamount to a catastrophe. The brightest and most respected former skeptics have conceded this much and now share the conviction that, once it has been set in motion, European Economic and Monetary Union must not fail."[31]

The Road Into the Crisis

Initially, monetary integration in the euro area was a success in economic terms.[32] In the medium term, the European Central Bank was largely able to maintain its target rate of inflation of close to but below two percent. The monetary union also resulted in deeper goods and capital market integration, as well as a marked conver-

24 Commission of the European Communities, "One market, one money: An evaluation of the potential benefits and costs of forming an economic and monetary union," *European Economy*, no. 44 (October 1990).

25 P. Bofinger, "Europa: Ein optimaler Währungsraum?," in "Europäische Integrationsprobleme aus wirtschaftswissenschaftlicher Sicht," eds. B. Gahlen, H. Hesse, and H. J. Ramser, *Wirtschaftswissenschaftliches Seminar Ottobeuren*, vol. 23 (Tübingen: J.C.B. Mohr (Paul Siebeck), 1994), 125–151.

26 J. Frankel and A. Rose, "The Endogenity of the Optimum Currency Area Criteria," *Economic Journal*, vol. 108, issue 449 (1997):1009–1025.

27 B. Eichengreen, "Is Europe an Optimum Currency Area?," *NBER Working Paper,* no. 3579 (1991).

28 T. Bayoumi and E. Prasad, "Currency Unions, Economic Fluctuations, and Adjustment: Some New Empirical Evidence," *IMF Staff Papers*, vol. 44(1) (1996): 36–58.

29 X. Sala-i-Martin and J. Sachs, "Fiscal Federalism and Optimum Currency Areas: Evidence for Europe From the United States," *NBER Working Paper*, no. 3855 (1991).

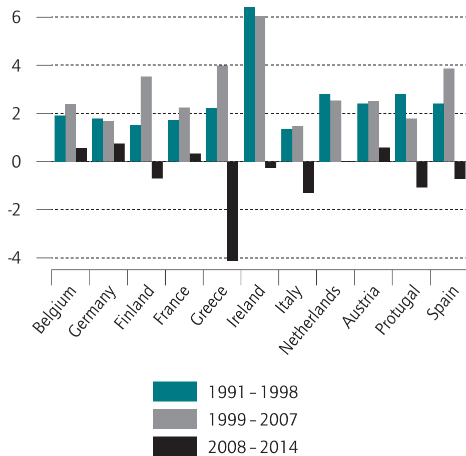
30 A very different position is advocated by Charles Wyplosz, "EMU – Why and How It Might Happen," *Journal of Economic Perspectives*, vol. 11, no. 4 (1997): 3–21. He argues that the convergence criteria fixed in the Maastricht Treaty very much underline the dominance of the economistic school of thought. What is not considered, however, is that, from a strictly economistic perspective, this constitutes, at best, a compromise with the monetarist camp.

31 O. Issing, " Europe: common money - political union?," FAZ lecture held on September 20, 1999 in Frankfurt, https://www.ecb.europa.eu/press/key/date/1999/html/sp990920.en.html.

32 H. Tietmeyer, *Herausforderung Euro* (Munich, Vienna: Carl Hanser Verlag, 2005): Chapter 23.

Figure 1

Growth Before and After Introduction of the Euro
Average Yearly Growth Rate of Gross Domestic Product (in Percent)



Source: International Monetary Fund.

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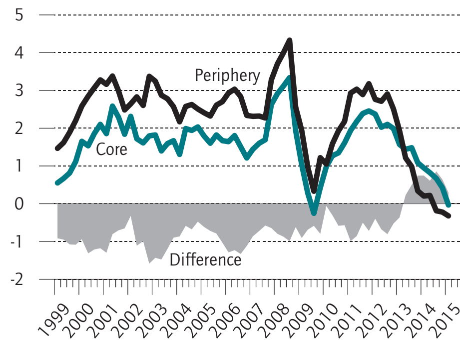
Figure 2

Inflation in Euro Area Countries
Y-o-y Change in Price Level (in Percent)



Core: Belgium, Germany, Finland, France, Netherlands, Austria.
Periphery: Greece, Ireland, Italy, Slovenia, Slovakia, Spain, Portugal.
Weighted by nominal gross domestic product.

Source: OECD, National Statistical Authorities.

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gence of interest rates on public and private debt.[33] As a result of these developments, in the years immediately after the introduction of the common currency until the onset of the global financial crisis in 2007, many member states experienced a stronger economic development than in the previous decade (see Figure 1).[34]

The inflation rates of the individual member states also converged to the inflation target of the ECB, although differences prevailed (see Figure 2).[35] These led (given almost identical nominal interest rates) to diverging real interest rates, which in those countries with stronger price development—driven to some extent by considerable divergences in the development of wages[36] and shortcomings in fiscal discipline[37]—generated excessive debt-financed demand and fostered the development of substantial current account imbalances (see Figure 3).[38] Without an autonomous monetary policy, the individual countries did not have the all-important adjustment mechanism to counter such unfavorable developments promptly. Other control mechanisms and instruments—alternatives to monetary policy which could have been employed to keep, in particular, private and public debt at a sustainable level—were not created while the monetary union was being fashioned, nor were they developed in the first ten years of the monetary union's existence.

Brought on by the global financial crisis of 2008 and 2009, tension grew within the European Monetary Union. Contrary to the common belief that a balance of payments crisis cannot happen within a monetary union, a reversal of capital flows took place. Debt-financed growth in the individual countries whose current account deficits were already considerable came to a halt, resulting in a vicious circle that, to this very day, has not been broken: undesirable developments in the banking system, public finances, and the real economy mutually inten-

33 See R. Baldwin et al., "Study on the Impact of the Euro on Trade and Foreign Direct Investment," *European Economy-Economic Papers* (2008): 321.

34 See F. P. Mongelli and C. Wyplosz, "The euro at ten – unfulfilled threats and unexpected challenges," manuscript, *Fifth ECB Central Banking Conference* (2009), https://www.ecb.europa.eu/events/pdf/conferences/cbc5/Mongelli_Wyplosz.pdf?d045ab7c3ac1f189381c5af61a274ae8.

35 I. Angeloni and M. Ehrmann, "Euro Area Inflation Differentials," *The B.E. Journal of Macroeconomics* 7(1) (2007): 1–36.

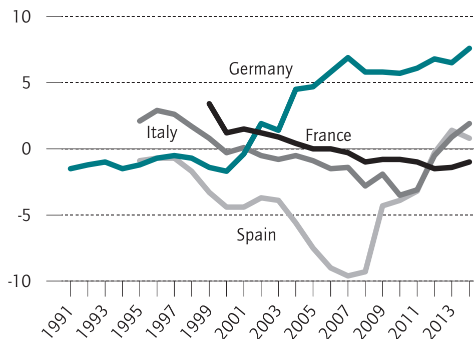
36 For a more detailed description, see U. Fritsche et al., "Auswirkungen von länderspezifischen Differenzen in der Lohn-, Preisniveau und Produktivitätsentwicklung auf Wachstum und Beschäftigung in den Ländern des Euroraums," research project commissioned by the German Federal Ministry for Economic Affairs and Labour (Bundesministerium für Wirtschaft und Arbeit), *DIW Berlin: Politikberatung kompakt*, no. 8.

37 European Central Bank (2003), Monthly Bulletin December 2003: 53–55.

38 C. Wyplosz, *The Eurozone Crisis – It's about Demand, not Competitiveness*, mimeo. (The Graduate Institute: Geneva, 2013); Mongelli and Wyplosz, "Euro at ten." Ahead of many in examining the problem of real interest divergence in fixed exchange rate systems was Sir Alan Walters, advisor to the then British Prime Minister Margaret Thatcher; see A. Walters, *Sterling in Danger – The Economic Consequences of Pegged Exchange Rates* (Fontana/Collins, 1990).

Figure 3

Current Account Imbalances in the Euro Area
Current Account Surplus
(in Percent of Gross Domestic Product).



Source: Eurostat.

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sified, resulting in a spiral of economic distortions and prevailing uncertainty among market players.[39]

During the crisis, at the latest, it became evident that the convergence criteria outlined in the Maastricht Treaty were not sufficiently comprehensive: both balance of payments imbalances and the development of private sector debt were excluded. At the same time, during the creation of the monetary union, the main focus was on the institutional framework of the European Central Bank, while other areas—a common banking supervision[40], a lender of last resort for countries[41], or an institutionalized sovereign debt restructuring mechanism[42]—were disregarded entirely.[43]

Crises as a Pacemaker of European Integration?

Essentially, the monetarist expectation that the introduction of the single currency would result in enhanced integration and coordination on economic policy matters remained largely unfulfilled, at least in the initial years of monetary union; it was only in response to the crisis in the euro area after 2010 that selective changes to the institutional framework in the euro area have been pushed through: This is exemplified by the 2012 European Fiscal Compact, the EU six-pack, or the supranational banking union agreement which illustrate at which speed the crisis acted as a catalyst and enforced modifications to the institutional framework of the monetary union, which should in fact have been carried out before the crisis.

In practice, therefore, the creation of the monetary union proved to advance integration. And yet, even since the inception of the common currency, political decision-makers were probably aware of the fact that a process like this could potentially cause considerable tension. Testimony to this is a statement by the then President of the European Council Romano Prodi in 1999: "I am sure the euro will oblige us to introduce a new set of economic policy instruments. It is politically impossible to propose that now. But some day there will be a crisis and new instruments will be created."[44]

In a similar vein, German Foreign Minister Joschka Fischer wrote in 1999 that "the creation of a common currency results in a situation of tension induced by the absence of common political and democratic structures, tension whose momentum will shatter the current status quo in the very near future."[45] And even in 2011, German Minister of Finance Wolfgang Schäuble was quoted as saying "we can only achieve a political union if we have a crisis."[46]

Thus, in line with what one may call a "nasty accident theory"[47] of European integration, crises are almost desired in the monetary union, as these generate the political justification needed to further the integration process. Taking a fatalist stance towards Jean Monnet's dictum that people only accept change in necessity and see necessity only in crisis,[48] it is argued that crises are an integrative force. For this reason, the general accept-

39 For more details on the vicious circle of the bank, national debt, and macroeconomic crisis, see J. C. Shambaugh, *The Euro's Three Crises* (2012), http://www.brookings.edu/~/media/Projects/BPEA/Spring%20 2012/2012a_Shambaugh.pdf.

40 F. Bremus and C. Lambert, "Banking Union and Bank Regulation: Banking Sector Stability in Europe," *DIW Economic Bulletin*, no. 9 (2014).

41 G. Illing and P. König, "The European Central Bank as Lender of Last Resort," *DIW Economic Bulletin*, no. 9 (2014).

42 C. Große Steffen and J. Schumacher, „Debt Restructuring in the Euro Area: How Can Sovereign Debt Be Restructured More Effectively?," *DIW Economic Bulletin*, no. 10 (2014).

43 For an overview of the necessary institutional reforms in the euro area, see also F. Fichtner et al., "Making the Euro Area Fit for the Future," *DIW Economic Bulletin*, no. 9 (2014).

44 Interview with Romano Prodi, *Financial Times*, 1999.

45 J. Fischer, "Die Bürger wollen wissen, wohin die Reise geht," *Frankfurter Rundschau*, February 3, 1999), cited in F. Niess, *Die europäische Idee – Aus dem Geist des Widerstands* (Frankfurt am Main: Suhrkamp Verlag, 2002): „(…) aus der Vergemeinschaftung der Währung gegenüber den noch fehlenden politischen und demokratischen Gemeinschaftsstrukturen [wird] ein Spannungsfeld entstehen, dessen Dynamik den gegenwärtigen Status quo bereits in naher Zukunft erschüttern wird".

46 W. Schäuble, "Seeing in Crisis the Last Best Chance to Unite Europe," *New York Times*, November 18, 2011; in the original: "We can only achieve a political union if we have a crisis."

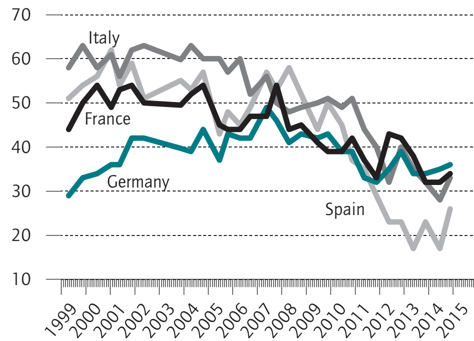
47 G. Rachman, "Super-Sarko's Plans for the World," *Financial Times*, October 20, 2008.

48 J. Monnet, *Mémoirs* (Paris: Fayard, 1976), 129: "Les hommes n'acceptent le changement que dans la nécessité et ils ne voient la nécessité que dans la crise."

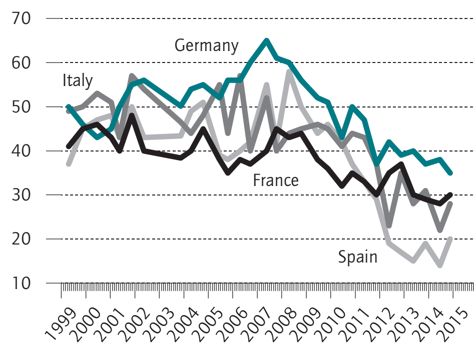
Figure 4

Trust in ...
In Percent[1]

... the European Commission



... the European Central Bank



1 Proportion of respondents that answered "Tend to trust" to the question "Please tell me if you tend to trust or not to trust in the ...".

Source: Eurobarometer.

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ance of change and reforms by the public is not an absolute must for political integration; accordingly, waving a "there is no other alternative" banner, reforms can be pushed through despite political opposition.

Political calculation such as this is not without its risks, however. The adjustment burden resulting from the current crisis has generated exceedingly high and direct, palpable costs, placing considerable pressure on the people of the countries affected worst. Willingness to bear such burden is rather limited and this has shaken the political landscape considerably, as can be seen almost all over Europe. Against this background, the commitment to deeper integration has diminished, and support for the idea behind a monetary, fiscal, and political union, as well as the Union's institutions has waned significantly (see Figure 4). According to the monetarist position, the integration process driven by the creation of a monetary union requires the single currency to be introduced irrevocably; however, crisis-induced tension which, in the best-case scenario, would foster integration could trigger a process which could just as easily lead to disintegration.

Conclusion

In his treatise *Exit, Voice, and Loyalty*, Albert Hirschmann discusses the options that a population has when faced with institutions it is dissatisfied with.[49] A stance that relies on the momentum inherent in crises to set the pace of integration risks the population expressing their dissatisfaction by choosing the *exit* option and the European integration process losing all support. The costs involved in returning to national currencies are both incalculable and in all likelihood extremely high. However, having said that, crises can be very expensive for the population, meaning that a nasty-accident integration policy cannot rule out the possibility of the European integration project being a success.

Hence, the monetarist strategy, relying on the common currency as a pacemaker for the integration process and thereby accepting deep and severe crises, is extremely fragile. This is illustrated by the recent dramatic developments in Greece. The economic divergences that were built up since the country's introduction of the common currency, have, over the past few years, caused massive economic and social distortions. As a consequence, at the beginning of 2015, a government was elected that refused to support the established economic policy consensus in the monetary union. In this way, the economic turmoil paved the way for political tensions between Greece and the other member states, which, almost exactly 25 years after the removal of capital controls in Europe, enforced the introduction of capital controls in Greece and threatens to cause the exit of Greece from the common currency.[50]

In light of this, it would be advisable to return to the idea of parallelism of monetary integration and economic cooperation as enshrined in the Maastricht Treaty which in some respects took account of economistic considerations. In future, European policy should focus more on this notion and foster political integration both actively and in democratic discourse with the population, thus allowing it to raise its *voice*, rather than allowing themselves to be driven by crisis. This is very likely to underpin the *loyalty* from which Europe and the single cur-

49 See A. Hirschmann, *Exit, Voice, and Loyalty* (Harvard University Press, 1970).

50 At the time of printing of this DIW Economic Bulletin, the consequences of the failure of the negotiations between Greece and its European partners about the extension of the financial support programmes were not conceivable.

rency takes its strength and, according to Hirschmann's theory, should reduce the relevance of the *exit* option. This is all the more valid in view of the fact that the end of the single currency would also mean the end, at least temporarily, of the entire political integration process, sending Europe back to times way before 1990, when on July 1 the removal of capital controls paved the way for the common currency.

Ferdinand Fichtner is Head of the Department of Forecasting and Economic Policy at DIW Berlin | ffichtner@diw.de

Philipp König is a Research Associate in the Department of Forecasting and Economic Policy at DIW Berlin | pkoenig@diw.de

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DIW Berlin — Deutsches Institut für Wirtschaftsforschung e. V.
Mohrenstraße 58, 10117 Berlin
T +49 30 897 89 -0
F +49 30 897 89 -200

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Press office
Renate Bogdanovic
Tel. +49-30-89789-249
presse @ diw.de

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