

22

Economic and Monetary Union

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Chapter Contents

- 22.1 Introduction 325
- 22.2 What is economic and monetary policy? 325
- 22.3 From The Hague to Maastricht (1969–91) 327
- 22.4 From treaty to reality (1992–2002) 329
- 22.5 Explaining economic and monetary union 331
- 22.6 Criticisms of economic and monetary union 332
- 22.7 The global financial crisis and the sovereign debt crisis 335
- 22.8 A new European Commission, Parliament, and the COVID-19 crisis 336
- 22.9 Conclusion 337

Reader's Guide

This chapter introduces economic and monetary union (EMU). It describes the key components of EMU and what happens when countries join. EMU was the result of decades of collaboration and learning, which have been subdivided here into three periods: 1969–91, from the agreement to creation to its inclusion in the Treaty on European Union (TEU); 1992–2002, from having the plans for EMU to the irrevocable fixing of exchange rates; and 2002 onwards, when EMU had been established, and euro banknotes and coins were circulating in member states. Next, the chapter reviews various theoretical explanations, both economic and political, accounting for why EMU was created and looks at some criticisms of EMU. Finally, the chapter discusses how EMU has fared under the global financial crisis, the sovereign debt crisis and the COVID-19 pandemic. These crises brought to the fore various imperfections in the design of EMU and provided opportunities for further development. This section discusses what changes have been made since 2009 to address those flaws and looks at what may be yet to come.

22.1 Introduction

Euro banknotes and coins were introduced on 1 January 2002. On that date, the euro became legal tender in 12 EU member states, among a total of more than 300 million people. Denmark, Sweden, and the United Kingdom (UK) did not participate. This event signalled the start of a new era in the history of the EU not least because, at this point, the majority of EU citizens were in daily contact with a concrete symbol of **European integration**. What was the path that led to the euro?

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

22.2 What is economic and monetary policy?

Having a common currency among distinct European nations has occurred before: the Roman empire had a single currency two thousand years ago. From 1865 to 1927 Belgium, France, Italy, Switzerland, and others were part of a Latin monetary union (LMU). They minted francs that were of equal value across their union. In 1872, the Danes, Norwegians, and Swedes launched a single currency, the Scandinavian krona, used until 1914. Although the nineteenth-century European monetary unions were significant, the scale and scope of EMU in the EU was further reaching, because these earlier unions only **harmonized** coinage and did not introduce a **single monetary policy** or a **central bank**. Furthermore, the financial system has since undergone a major transformation and the role of the state has expanded enormously over the past century. EMU is thus the most ambitious monetary union to date.

22.2.1 The component parts of EMU

EMU, as set out in the Maastricht Treaty, refers to a union of participating countries which have agreed to

a single monetary policy, a single monetary authority, a single currency, and coordinated macroeconomic policies. Central banks formulate and implement monetary policy, in some cases in collaboration with the government—that is, with the ministry of finance and sometimes also with the economics ministry. In EMU, monetary policy is no longer formulated at the national but at the European level by a single monetary authority: the **European Central Bank (ECB)**.

The December 1991 Maastricht European Council agreed to create a **European System of Central Banks (ESCB)**, consisting of the ECB and the national central banks of all EU member states. By mid-2021 19 EU member states had adopted the euro in what is officially called the '**euro area**' (informally '**euro-zone**'). The term '**Eurosystem**' denotes the ECB plus the national central banks—the latter becoming merely 'branches' of the ECB. The Governing Council is the ECB's main decision-making body. The ECB is responsible for the single currency. It sets monetary policy: sets a key **interest rate**, monitors the **money supply** and **credit conditions**. To facilitate coordination of economic and financial policies, an informal ministerial group has been set up: the so-called '**Eurogroup**'. It consists of the euro area member states' ministers of finance, and sometimes economics, to coordinate policies. The formal body to deal with EU level economic and financial matters is called the Ecofin Council and all EU member states take part.

To have a successful mix of monetary policy and fiscal policy (taxing and spending), EMU envisages the coordination of economic policies (Article 121 TFEU). The euro was geared to be a low-inflation currency, its primary objective being price stability. To secure that objective there are rules in the Treaty on **public debts** and **budgetary deficits**. Member states must avoid budget deficits in excess of a so-called **reference value** of 3 per cent of **gross domestic product (GDP)** and general government debt should be at or below 60 per cent of GDP. Furthermore, monetary financing is not permitted: euro area countries may not use the printing press to create money to service their debt. This so-called '**no-bailout clause**' was put in place to reduce the likelihood of one member state assuming the debt of another or for the EU as a whole (for example through the ECB) to take over some of the debt of a member state should it be unable to pay its debts (Article 125 TFEU). Prior to EMU, a member state that ran high budget deficits or debt would have been '**punished**' by the market, because it would have

needed to pay higher interest rates than other member states to attract funds in the market. In EMU this mechanism was expected to disappear (which indeed occurred as long-term interest rates of EMU countries converged right after the start of EMU until the sovereign debt crisis). The rules on debts and deficits and the no-bailout clause were to be put in its place to ensure that no country would take advantage of being in EMU and issue too much debt.

Finally, a central bank may aim to target a particular value of the currency vis-à-vis other currencies. The ECB has mostly considered the external value of the euro as subordinate to its primary aim, which is to achieve price stability (set as close to, but not more than, 2 per cent inflation). Furthermore, because of a situation dubbed by Tommaso Padoa-Schioppa as an 'inconsistent quartet', the euro has typically been left to market forces and thus floats freely against other major currencies. The inconsistent quartet means that under conditions of free trade, free capital markets, and fixed exchange rates one cannot also have autonomous monetary policy.

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

The question of how to reach EMU had already been discussed in some detail by economic thinkers of the 1960s such as Bela Balassa and Jan Tinbergen. According to these and others, economic integration can be subdivided into a number of stages (see also Chapter 20) that range from more minimal to more extensive integration. The least far-reaching form of integration is a **free trade area (FTA)**. In an FTA,

participating members remove **barriers to trade** among themselves, but maintain the right to levy tariffs on third countries. The next stage of integration is a **customs union**. In addition to the free trade among members, a customs union has **common external tariffs** on goods and services from third countries. A **common market**—since 1985, renamed **Single Market**—is characterized by the free movement of goods, services, labour, and capital among the participating states, and common rules, tariffs, and so on vis-à-vis third countries. An **economic union** implies not only a common or Single Market, but also a high degree of coordination of the most important areas of economic policy and market **regulation**, as well as monetary policies and income redistribution policies. A **monetary union** contains a common or Single Market, but also further integration in the area of currency cooperation. Historically, deeper integration has not always been part of a monetary union: the Scandinavian monetary union did not contain a customs union. A monetary union either has irrevocably fixed exchange rates and full **convertibility** of currencies, or a common or single currency circulating within the monetary union. It also requires integration of budgetary and monetary policies. An EMU combines elements of both economic and monetary union (which is what the EU Council in 1969 and in the late 1980s envisaged). A **full economic union (FEU)** implies the complete unification of the economies of the participating member states and common policies for most economic matters. **Full political union (FPU)** is when, in addition to the FEU, much of the political governance and policy-making has transferred to the **supranational** level. Effectively, political unification occurs when the final stage of integration has taken place and a new **confederation** or federation has been created.

The eventual institutional design of EMU in the 1980s and 1990s was an asymmetrical one (Verdun, 1996, 2000). It featured a relatively well-developed monetary union, but a much less developed economic union. Monetary policy was to be transferred to a new **supranational institution** (the ECB), whereas in the area of economic policy-making decisions remained the full responsibility of national governments. To some extent, one observes here the difference between positive and negative integration. **Positive integration** refers to the creation of common rules, norms, and policies. **Negative integration** is all about taking away obstacles—eliminating rules and procedures that are an obstruction to integration.

KEY POINTS

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

22.3 From The Hague to Maastricht (1969–91)

At the 1969 Hague Summit, the heads of state and government decided to explore a path to economic and monetary union. A group of experts, headed by Pierre Werner, prime minister and finance minister of Luxembourg, drafted the blueprint. The 1970 **Werner Plan** proposed three stages to reach EMU by 1980. It recommended setting up two supranational bodies: a Community System for the Central Banks and a Centre of Decision for Economic Policy. The former would conduct monetary policies, while the latter would coordinate macroeconomic policies (including some tax policies). Although most of the recommendations of the Werner Plan were adopted, the process stalled in the 1970s. Circumstances changed dramatically and member states had different ideas about how to deal with them. For example, the **Bretton Woods agreement** that had facilitated stable exchange rates in Western Europe since 1945 ended in August 1971. West European countries responded to its demise by setting up their own **exchange rate mechanism (ERM)**, the so-called '**snake**'. However, it only functioned with moderate success throughout the 1970s, and not all member states participated, although several non-members were involved.

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

The **European Monetary System (EMS)** was set up in 1979. Not all European Community (EC) member states were immediately part of its most important

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

The ERM needed some time to become successful. The first four years (1979–83) were learning years, with numerous exchange rates fluctuations and parity adjustments. The participating currencies became more stable in the interim period (1983–7). In 1987 the Basel–Nyborg accord stipulated closer cooperation so that early intervention would be possible to offset the chances of realignment. Indeed, until summer 1992, the ERM witnessed no realignments. The EMS had finally become an important 'symbol' of successful European integration. In the 1980s, the West German currency, the Deutschmark, was a **strong currency**, and became the *de facto* 'anchor currency'. Monetary authorities in ERM countries took German monetary policies as their point of reference and closely followed the decisions of the German central bank (the *Bundesbank*).

A few other developments in the 1980s helped to revive the EMU process. The 1986 **Single European Act (SEA)** facilitated the completion of the Single Market and mentioned the need to relaunch EMU. The 1988 Hanover European Council mandated Commission President Jacques Delors to head a committee composed of the 12 central bank presidents, another

BOX 22.1 BACKGROUND: THREE STAGES TO ECONOMIC AND MONETARY UNION

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

Commissioner, and a few experts to draft a blueprint for EMU. Just as the earlier **Werner Report**, the **Delors Report** (April 1989) proposed a road to EMU in three stages (see Box 22.1), including the creation of a European System of Central Banks (ESCB). In contrast to the Werner Report, it did not find it necessary to set up a similar supranational institution in the economic sphere. The Delors Report had the same objectives as the earlier report: full freedom of goods, services, capital, and labour, and, if possible and if the political will was there, the introduction of a single currency. On the basis of the Delors Report, the June 1989 Madrid European Council adopted the EMU blueprint, with the first stage of EMU (the **liberalization of capital markets**) starting on 1 July 1990. An **intergovernmental conference (IGC)** opened in Rome in October 1990 and closed in Maastricht in 1991 to discuss the next stages (see Chapter 2). To join EMU, countries would have to meet the '**convergence criteria**' (see Box 22.2): good performance in the area of inflation rates, interest rates, and exchange rates. Moreover, it was agreed that participating countries should not have excessive budgetary deficits or public debts. National central banks needed to be politically independent, and no monetary financing was to be allowed. It is important to note that, right from the outset, there were 'escape clauses' built into the legal provisions. The criteria had leeway with regard to the debt criterion, because countries, such as Belgium and Italy, would not be able to meet the reference value in less than a decade, so language was included to allow

BOX 22.2 BACKGROUND: THE MAASTRICHT CONVERGENCE CRITERIA

- Budget deficits should be no more than 3 per cent of gross domestic product (GDP).
- Accumulated public debt should be no more than 60 per cent of GDP.
- Exchange rates should have participated without devaluation or severe tensions in the exchange rate mechanism (ERM-2) for at least the previous two years.
- Inflation should not be more than one and a half percentage points above the rate of the three best-performing member states.
- Long-term interest rates should be not be more than two percentage points above the rate of the three best-performing member states.

Source: Article 140 TFEU and Protocol 12.

for continuous and downward development of the level of public debt. As for the budgetary criterion, however, this one *had* to be met.

Many have argued that the creation of EMU was assisted by the fall of the Berlin Wall in 1989, and the end of communist regimes in Central and Eastern Europe (CEE) in 1990. The observant reader will have noted, however, that the Delors Report had already been commissioned in June 1988 and was completed by April 1989 and therefore preceded these turbulent

political developments. Nevertheless, the political determination of German Chancellor Helmut Kohl to secure EMU was connected to his eagerness to move ahead quickly with German unification. The IGCs were completed in December 1991, and the European Council in Maastricht agreed to revise the Treaty of Rome and accept a new Treaty on European Union (TEU). It was signed on 7 February 1992 and came into force on 1 November 1993, after the national parliaments of all 12 member states ratified it.

KEY POINTS

- In the 1970s, EMU stalled because of differences among member states and changing international circumstances.
- The European Monetary System and the Single European Act contributed to the relaunch of EMU in the late 1980s.
- The 1989 Delors Report offered a blueprint for EMU.
- The treaty changes necessary for acceptance and implementation of EMU were negotiated in an intergovernmental conference, which was completed in Maastricht in 1991. Member states need to meet the 'Maastricht convergence criteria' to join EMU.

22.4 From treaty to reality (1992–2002)

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

22.4.1 Ratification problems and the 'real' convergence criteria

The ratification process of the Maastricht Treaty turned out to be challenging. Only months after the Treaty was signed, on 2 June 1992, Danish citizens voted against it in a referendum. A razor-thin majority rejected the Treaty (50.7 per cent against; 49.3 per cent in favour). A French referendum was held on 20 September 1992. Against the background of major speculation in the financial markets, which had resulted in the British pound sterling and the Italian lira leaving the ERM days before the referendum, the

French referendum resulted in a very slim majority in favour of the Treaty (51 per cent in favour; 49 per cent against). The period from late 1992 through to early 1994 was characterized as one of continued exchange rate turbulence, placing the ERM under further pressure and casting a shadow on the run-up to EMU. In August 1993, the ERM exchange rate bands were widened from ± 2.25 per cent to ± 15 per cent. After the introduction of the euro, a new system, the ERM II, was set up to succeed the previous ERM. It officially maintained the ± 15 per cent bands.

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

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

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

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

The SGP involves multilateral budgetary surveillance (a 'preventive arm'), as well as specifying a deficit limit, the excessive deficit procedure (EDP) (a 'corrective arm') (see Box 22.3). When, on the basis of



BOX 22.3 BACKGROUND: THE STABILITY AND GROWTH PACT

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

Dates	Decisions
The SGP comprised a European Council Resolution (adopted at Amsterdam on 17 June 1997) and Regulations of 7 July 1997 The Council Regulations were revised on 27 June 2005 The rules were further strengthened in 2010 and 2011 ('six pack'), in 2012 (the Treaty on Stability, Coordination and Governance) and in 2013 ('two pack')	The surveillance of budgetary positions and coordination of economic policies Implementation of the excessive deficit procedure (EDP)
Annually since 1999	Member states have undertaken to pursue the objective of a balanced, or nearly balanced, budget, and to present the Council and the Commission with a stability programme Euro-outs (member states not taking part in the third stage of EMU) are also required to submit a convergence programme Opening and closing (where appropriate) of an excessive deficit procedure for EU member states
Since 2010, procedures strengthened, streamlined, and formalized with the European Semester	The European Commission analyses the fiscal and structural reform policies of each member state, provides recommendations, and monitors their implementation; the member states implement the commonly agreed policies
COVID-19 pandemic	Activation of the 'General Escape Clause'. Does not suspend the procedures of the SGP, but allows the Commission and the Council to depart from the budgetary requirements that would normally apply

a Commission recommendation, the Council decides that an excessive deficit indeed exists, the member state concerned is obliged to reduce its deficit below the Treaty's reference value of 3 per cent of GDP; otherwise financial sanctions can be levied against the member state in question.

In 2002, France, Germany, and Portugal were given an 'early warning' that they were in breach of the SGP. Portugal made the necessary corrections so the EDP was abrogated in 2004. But France and Germany failed to make the necessary adjustments to reduce their budgetary deficits and were coming closer to the financial sanctions set out in the SGP. At a November 2003 ECOFIN meeting a proposal by the Commission to move closer to sanctions against France and Germany was defeated. The result was that the SGP was interrupted for the cases of France and Germany. The crisis atmosphere prompted the European Commission to ask the Court of Justice of the EU (CJEU) whether this Council decision was legal. In July 2004,

the CJEU ruled that the November 2003 Council decision was, in fact, *illegal* because the Council had adopted its own text outside the context of the Treaty. The Court ruled that the Council has the right not to follow the recommendations of the Commission. By spring 2005, the SGP formal rules were revised to provide more **flexibility** over the circumstances under which member states could temporarily run deficits in excess of the 3 per cent reference value, and small adjustments were made to the time schedule.

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

medium term, whereas a balanced budget or a surplus is required for countries with a combination of high debt and low potential growth. The preventive arm of the SGP was strengthened because member states committed to consolidate further their public finances when facing favourable economic conditions and accepted that, failing this, the Commission would give them 'policy advice' to correct the situation. The new agreement was also more sensitive to the effects of member state efforts to make structural reforms. The SGP's corrective arm also allowed more room for economic judgements and left open the possibility that the one-year deadline for the correction of an excessive deficit could be increased to two years.

The first test of the new SGP came in the second half of 2008 when the global financial crisis upset markets and challenged the survival of the banking sector. Member state governments in the EU responded by guaranteeing the savings of consumers, buying out banks, and offering other stimulus packages. Due to their sheer size, public finances were affected by these national rescue operations. The rules of the SGP still applied, however, even if, because of the economic crisis, these countries were allowed to overshoot the reference value for the duration of the downturn. Once growth returned, they needed to satisfy the rules of a budgetary deficit of 3 per cent and there are stricter rules if member states have a public debt in excess of 60 per cent.

The global financial crisis, the economic recession, and the sovereign debt crisis changed the perceived importance of the role of the SGP in guiding EMU. Some of the rules were strengthened (see Chapter 25 and Section 22.7, 'The global financial crisis and the sovereign debt crisis').

KEY POINTS

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

22.5 Explaining economic and monetary union

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

22.5.1 An economics perspective

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

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

22.5.2 A political science perspective

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

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

An **intergovernmentalist** explanation (see Chapter 5) argues that EMU can best be understood

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

KEY POINTS

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

22.6 Criticisms of economic and monetary union

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

22.6.1 Countries outside the euro area

The Danes and Swedes have not joined the euro. In both countries, a referendum on EMU was held (in Denmark, in 2000; in Sweden, in 2003) and in both

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

The global financial crisis, the economic recession, and the sovereign debt crisis have had varying effects on member state perception of EMU. Initially, in 2007 until summer 2008, various currencies of EU member states that had remained outside the euro area did better than the euro. Yet, in the autumn of 2008 and the first months of 2009 the euro strengthened against currencies such as the Czech koruna, the Polish zloty, or the Hungarian forint. But as currencies weakened, this benefited the export sector and was regarded as a factor that could assist in a speedier recovery following the economic downturn or recession after the financial crisis. Some have criticized the design of the euro as being too much focused on price stability, meaning that the mandate of the ECB is to consider first and foremost the internal management of the euro (to ensure price stability) rather than, for example, at what exchange rate the euro area might be more competitive at the global level. Especially in the early 2000s, when the euro area countries were growing more slowly than countries outside the euro area (and again during the sovereign debt crisis), the criticism was often that the ECB could only consider growth as a secondary consideration. All in all, support for the euro has been varied. Roughly 70 per cent of both the Danish and Swedish populations are still against adopting the euro as their national currency (Eurobarometer 94, 2021). The ten member states that joined the EU in 2004 have also had varying attitudes to euro adoption. The seven that have joined to date (Slovenia, Cyprus, Malta, Slovakia, Estonia, Latvia, and Lithuania) have been keen to do so. In 2021, 79 per cent of those in the euro area support EMU (Eurobarometer 94, 2021). Those that have remained outside have done so for a variety of reasons. The three CEE member states that are still outside the euro area, as of 2021, have a government and population that are reluctant to join even if they are currently not too far removed from meeting the criteria for entry, which focus on inflation, deficit, debt, and long-term interest rates. None of them, however, participate in the exchange rate mechanism and will mostly likely only start doing so if and when they become more supportive of the idea of joining EMU. In all cases, these countries have

the formal requirement that they are obliged to join EMU once they meet the criteria. It should be noted that this is a formality because countries, such as Sweden, can stay outside the euro area simply by having their currencies not enter the ERM in the first place.

22.6.2 Criticism of EMU's institutional design

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

Let us clarify this fourth issue a little further. Compared to mature federations, the institutional design of EMU is incomplete: the ECB decides monetary policies for the entire euro area, yet there is no equivalent supranational economic institution that sets economic policies for that same area. Budgetary and fiscal policies remain in the hands of national governments. Although countries such as France argued strongly in favour of creating such a *gouvernement économique* ('economic government'), in the early days the choice was made not to go down that route.

National fiscal policies differ significantly across the EU 27. Some member states have a high income tax burden whereas others have a much lower

income tax burden; the same holds for the levels of corporate taxation, which is much higher in some countries than in others. To give an example, in 2019, total tax revenues in France, Denmark, and Belgium were just under 50 per cent of GDP, double that of Ireland—which collected less than 25 per cent in tax. In terms of spending, here too some member state governments spend a much larger percentage of the country's GDP than others. On the whole, member states may pick their preference for how much they tax and spend but the outcome of their choices should not exceed the so-called public debt (60 per cent of GDP) and budgetary deficit targets (3 per cent of GDP). In a similar vein there is an expectation about other macroeconomic factors that can be deemed out of balance (e.g., current account balance, net international investment position, cost of labour, house prices, and unemployment). If national policy choices lead to what is referred to as **macroeconomic imbalances**, the EU deals with these divergences through the so-called **European Semester** (see Box 22.4). The European Commission provides so-called '**country-specific recommendations**' (CSRs) with suggestions as to which imbalances to address. Member states, in turn, obtain the opportunity to respond to these recommendations.

What are the advantages and disadvantages of having a European economic government? The

advantages would be that EU level policies could possibly correct imbalances. However, an economic government would make sense only if a majority of the citizens of the euro area were to feel comfortable with it. If it were not to have that support, then a decision by such a body would be deemed illegitimate. The current situation in the EU is that most citizens feel most comfortable with their national government taking on the role of taxing and spending.

KEY POINTS

- The Czech Republic, Hungary, Poland, and Sweden are not planning to join the euro area in the near future, nor is Denmark—the latter has a formal opt-out from EMU.
- There has been criticism of the institutional design of EMU.
- Some concerns relate to the independence of the European Central Bank and how this raises questions about legitimacy and accountability.
- Fiscal policies in the EU differ considerably from country to country which leads to difficulties in adjusting in a coherent fashion to the challenges posed by the global financial crisis and the sovereign debt crisis.
- The institutional design of EMU has been criticized for being incomplete and falling short of 'an economic government'.



BOX 22.4 BACKGROUND: THE EUROPEAN SEMESTER

The 'European Semester' is a governance architecture for socioeconomic policy coordination in the EU that was created in 2010 during the financial and sovereign debt crises and revamped in 2015. Its procedures build on, but also reformulate, the EU's pre-existing processes of fiscal, economic, employment, and social policy coordination, as these had developed during the 1990s and 2000s, including the Stability and Growth Pact (SGP), the Broad Economic Policy Guidelines (BEPGs), the European Employment Strategy (EES), the Lisbon Strategy and the Social Open Method of Co-ordination (OMC). The Semester was introduced as part of a panoply of far-reaching measures aimed at reinforcing EU economic governance in response to the euro crisis: the so-called 'Six-Pack', 'Two-Pack', and 'Fiscal Compact'. These measures included stronger and more 'automatic' sanctions for the SGP's Excessive Deficit Procedure (EDP); a new Macroeconomic Imbalance Procedure (MIP) for detecting and correcting non-fiscal imbalances (e.g., in

the housing market or current account) that could negatively affect other member states, based on a scoreboard of economic indicators, in-depth country reviews and recommendations, with financial sanctions for persistent non-compliance; *ex ante* review by the Commission of euro area national budgets; and Reverse Qualified Majority Voting (RQMV) for overturning Commission proposals under the excessive deficit and imbalance procedures. The Semester was also intended to serve as the governance architecture for 'thematic co-ordination' of member state policies towards the 'smart, sustainable and inclusive growth' objectives of the **Europe 2020 strategy**, which was explicitly designed to have a stronger social dimension than the preceding Lisbon Strategy, including specific guidelines and targets on poverty and social inclusion.

Source: Verdun and Zeitlin (2018)

22.7 The global financial crisis and the sovereign debt crisis

In 2007–08, a major financial crisis hit the global economy. The crisis was caused by a series of problems, many of them originating in the USA. However, the financial crisis and its aftermath affected the EU even more than it did the USA. After the collapse of investment bank Lehman Brothers in September 2008, stock exchanges crashed, credit dried up, and many banks were at risk of collapse. National governments responded by guaranteeing deposits, (partially) nationalizing banks, and by putting together rescue packages. In 2009, the real economy shrank. In the EU, almost all countries were showing negative growth or were in recession (defined as two successive quarters of negative growth). As the economic recession took hold of the EU, many member state governments chose to spend considerably more than they taxed, leaving them with high deficits and public debt. Some countries experienced problems in securing money in capital markets to refinance their debt (see Chapter 25). This situation posed immense challenges for the euro area, through pressures on financial markets, pressure on interest rates for governments to attract funds in capital markets, and vicious circles of lack of confidence in markets and government policies. The result was a major crisis in the EU and a need to create new tools and mechanisms, such as the **European Financial Stability Facility (EFSF)**—which was eventually replaced by the permanent **European Stability Mechanism (ESM)** that became operational in September 2012.

On 11 December 2011, ‘reinforced’ SGP rules entered into force. The so-called ‘six pack’ (five **regulations** and one **directive**) includes rules that kick in if member states fail to comply with the 3 per cent deficit and/or the 60 per cent debt criteria. Some of the changes include that the role of the debt is now taken to be as important as the deficit. In the past, the debt criterion was largely ignored. Another ‘reinforced rule’ is that it requires a qualified majority vote (QMV) to *stop* the sanctions (whereas before it required a QMV to *impose* sanctions on a member state that was facing financial sanctions). The changes to the SGP also provided the European Commission with a larger supervisory role in guiding member states through the fiscal year and ensuring sound policies over the medium term.

In 2012, two further regulations were introduced to strengthen euro area budgetary surveillance. These

entered into force in May 2013, and both increased the coordination of budgetary policies in the euro area starting with the 2014 budgetary cycle. The Treaty on Stability, Coordination and Governance (informally referred to as the ‘**Fiscal Compact**’), came into effect in January 2013. The Fiscal Compact is an intergovernmental treaty that was put in place to ensure even stricter compliance with SGP rules. The Treaty envisaged what were called ‘balanced budgets provisions’ (no more than 3 per cent budgetary deficit and other rules related to the debt-to-GDP-ratios) which were incorporated in domestic constitutions. The Treaty also envisaged fines if member states failed to comply with these rules. The above-mentioned ‘European Semester’, introduced in 2010, sought to capture this process of European Commission supervision of member state public finance over a six-month period. Finally, a so-called **Banking Union** was created to strengthen and extend the regulation of the banking sector. Its aim was to ensure that there was centralized supervision and resolution of banks in the euro area. Its four aims are a single rulebook for regulation of banks in the 27 member states; a **Single Supervisory Mechanism (SSM)**; a harmonized system of deposit guarantee schemes; and a **Single Resolution Mechanism (SRM)**, to provide a framework for banks in danger of failing. The rules were put in place to prevent bank crises, for example, by increasing the amount of funds that banks were required to hold (recapitalization). It also ensured that consumers’ deposits across the EU were guaranteed up to €100,000 in case of a bank failure (see Chapter 25).

In 2015, five presidents of EU institutions (European Commission, European Parliament, European Central Bank, European Council, and finally the Eurogroup) put forward a roadmap to deepen EMU. This Five Presidents’ Report envisaged two stages to complete EMU by 2025. Stage one, ‘Deepening by Doing’, was to be completed by summer 2017. It focused on using existing instruments to achieve further structural convergence and work towards fiscal coordination, enhancing democratic accountability, and seeking to complete the financial union (i.e. complete the Banking Union, launch what was known as the Capital Markets Union, and Reinforce the European Systemic Risk Board (see Chapter 25)). Stage two, ‘Completing EMU’, would require more far-reaching steps and envisaged making the convergence process more binding (via benchmarks for convergence). It also foresees the creation of a euro area treasury which would enhance

coordination but also accountability at the EU level. In March 2017 the European Commission published a **White Paper on the Future of Europe**. By the end of May the Commission issued a reflection paper that examined the way forward for EMU by 2025. It effectively served as a clarification of the steps to take that had been set out in the Five Presidents' Report. It emphasized the need to reduce social and economic divergences among euro area members, in view of the fact that the 'economic' part of EMU was still not as well developed as the 'monetary' part of EMU. Furthermore, the reflection paper recognized that stronger governance was possible. Rather than providing a single path, four principles were spelled out for deepening EMU. It stipulated that EMU should first of all ensure 'jobs, growth, social fairness, economic convergence and financial stability'. Second, it stated that 'responsibility and solidarity' as well as 'risk reduction or risk-sharing' should go together. A third point (something reinforced by President Juncker in his State of the Union speech of September 2017) was that the EMU should at all times remain accessible to all member states. Fourth and finally, the decision-making process had to be further democratically enhanced so as to ensure better democratic accountability. The reflection paper indicated that it was going to be necessary to share more competences and decisions about euro matters within a common legal framework. It pointed to the need to complete the Banking Union; in particular, the Single Resolution Fund and the European Deposit Insurance Scheme (EDIS) (see Chapter 25). This reflection paper envisaged the next stage to end in 2019 and achieve the final objectives by 2025.

KEY POINTS

- The global financial crisis posed major challenges to the euro area.
- Most countries in the EU faced a recession following the global financial crisis.
- The EU's reaction to the crisis involved new institutions, including changes to the Stability and Growth Pact, which increased the supervisory role of the Commission.
- The European Council agreed to the creation of a Banking Union in June 2012.
- The 2015 Five Presidents' Report and the 2017 Reflection Paper offer further insights into steps to take to deepen EMU.

22.8 A new European Commission, Parliament, and the COVID-19 crisis

The year 2019 was an important year for the European Union: it was a year that was dominated by the Brexit negotiations, European Parliament elections, and a new European Commission. The EP elections held in May 2019 saw a significant increase in voter turnout and a slight decline in the support for the two largest parties (See Chapter 11). The new Commission, presided over by Ursula von der Leyen, came into office on 1 December 2019. Its six priorities were a European Green Deal, preparing for the digital age, improving the economy, a stronger Europe in the world, promoting the rule of law, and enhancing democracy. It was also responsible for the final stages of the Brexit negotiations. The formal departure of the UK from the EU was on 31 January 2020.

These events were occurring as an unprecedented health crisis hit the EU member states: the COVID-19 crisis. The EU had been notified by the World Health Organization (WHO) at the end of December 2019 about the virus. EU health experts responded immediately through the European Centre of Disease Prevention and Control. Yet, the sheer size and shape of the COVID-19 crisis took the EU by surprise. Christine Lagarde, who had taken over from Mario Draghi as the President of the ECB, chose her words poorly when, on 12 March 2020, she announced that she was 'not here to close spreads'. On the eve of WHO declaring the coronavirus a pandemic and Europe its epicentre, what she had meant to say was that EU governments would need to take responsibility for fiscal policy. Unintentionally, her words sent the financial markets sharply down. The ECB quickly corrected the situation by providing a pandemic emergency purchase programme (PEPP): a temporary asset purchase programme of private and public sector securities. Initially, in March 2020, 750 billion euros were earmarked for this fund, but in June 2020 this was increased by 600 billion and again by another 500 billion in December, adding up to a total of 1,850 billion euros.

The European Commission agreed to take action to support, coordinate, and supplement national policy. The challenge posed by the COVID-19 crisis was in the realm of economic policy and provided an opportunity for EU member states to act in concert. Following various initiatives by member states and by the Commission, the European Council decided in

July 2020 to make available to member states grants and loans to help them overcome the likely economic downturn that was to occur as member states dealt with the pandemic through lockdowns and border closures. Member states provided their citizens and companies with financial support. The European Commission announced that the SGP rules were temporarily abandoned as were rules on state aid and banking regulations. The EU also sought to put in place a system for sharing medical supplies, as a mark of solidarity; and sought to use its size to negotiate on behalf of all EU member states over the cost of vaccines whilst also serving as a clearing house to obtain vaccines. EU member states also exchanged expertise. Although not all of these actions were equally successful (for instance vaccine delivery dates and availability were a challenge for some months), the EU member states did manage to collaborate. The use of the EU budget and providing funds through a Recovery and Resilience Facility was seen by many as an important marker of solidarity and collaboration. A temporary

measure was made available to draw funds from financial markets, issuing joint debt. Some have argued that issuing joint debt would be a major step towards deeper integration—towards Full Political Union (FPU). The steps taken in the EU are temporary but important lessons will be learnt from the experience—not unlike those that occurred in the past with temporary measures.

KEY POINTS

- After a shaky start, the ECB quickly set up an asset purchase programme to respond to the COVID-19 crisis.
- The European Council agreed to various initiatives offering grants and loans to member states in July 2020, and relaxing rules associated with the SGP, state aid, and banking.
- Although not all initiatives were successful, the EU played an important role in the sharing of medical supplies and the procurement and distribution of vaccines.

22.9 Conclusion

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

Economic and political motivations lay behind EMU. Although one can make a case for a purely economic rationale for monetary union, its ultimate creation cannot be understood without an appreciation of its political dimension. EMU is a new stage in European integration. It signals the capability of EU member states to take firm action together and it places the EU more clearly on the international map. Nevertheless, a number of issues remain unresolved. In discussing the asymmetrical EMU, the chapter has indicated how fragile the balance is between 'economic' and 'monetary' union. The sovereign debt crisis has also unearthed challenges in EMU institutional

design. Facilities were put in place to deal with some of the problems created by the euro area crisis, such as the European Stability Mechanism and the Banking Union. The COVID-19 crisis awarded the EU an opportunity to act in concert, which on the whole it did. Yet it is not unthinkable that, in the future, further integration might be needed in the area of 'economic union' or that steps will have to be taken towards further political unification, if only to redistribute more evenly the costs and benefits of EMU. At the same time, we have seen that European integration is a gradual process, which lacks legitimacy if pushed ahead too quickly (see Chapters 9 and 15).

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

The regional use of the euro has increased quite rapidly from being legal tender in 11 member states in 1999

to 19 member states two decades hence. Furthermore, it is conceivable that more countries (e.g., Bulgaria) may want to be ready to join the euro area in the not-so-distant future, thereby adding further to the euro area's credibility and strength. Others, such as the Czech Republic, Hungary, and Poland, are still reluctant to

join. Yet not all monetary unions in the past have lasted; EMU will survive only if it continues to be supported by the citizens, and by national and European politicians. Leaders will have to keep listening to the needs of their citizens. If they do so satisfactorily, the euro may well continue to have a very promising future.



QUESTIONS

1. Why was the term 'economic' and 'monetary' union used? What is an 'asymmetrical EMU'?
2. What are the 'convergence criteria' and why were they invented?
3. Why has the Stability and Growth Pact been difficult to implement?
4. What are two opposing political science theories explaining why EMU happened? Do you agree that they are opposing theories or are they complementary?
5. What are the main criticisms of EMU?
6. Discuss how the creation of EMU was both an economic and politically driven process.
7. How have the global financial crisis, the economic recession that followed, and the sovereign debt crisis impacted EMU governance?
8. How has the COVID-19 crisis advanced EMU?



GUIDE TO FURTHER READING

Brunnermeier, M.K., James, H., and Landau J.-P. (2016) *The Euro and the Battle of Ideas* (Princeton, NJ: Princeton University Press). Addresses how philosophical differences between euro area member states contributed to the euro crisis, and how to move beyond these challenges.

Dyson, K. and Featherstone, K. (1999) *The Road to Maastricht: Negotiating Economic and Monetary Union* (Oxford: Oxford University Press). An influential political science volume based on 280 interviews and documents.

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

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

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



Access the online resources to take your learning and understanding further, including extra multiple-choice questions with instant feedback, web links, answer guidance to end-of-chapter questions, and updates on new developments in EU politics.

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