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THE EURO'S POLITICAL ECONOMY RELEVANCE

This paper discusses the political economy relevance of the European common currency. Politics are just as important as economics – if not more important – to guarantee the longevity of a shared currency. The euro is clearly a political construct and its first significant crisis demonstrated that its survival is not only a political issue but also that it needs further political coordination among the Eurozone member states.

1. HISTORICAL BACKGROUND

In a full monetary union, the other extreme, participating currencies disappear and are replaced by a single currency managed by a common central bank. The main advantages of a monetary union are a reduced exchange rate risk (as companies and citizens can be certain that the exchange rates remain unchanged) and no more exchange costs. The biggest disadvantage is that participating countries lose some of their key policy instruments for regulating the economy by delegating their right of making monetary policy and setting interest rates to a central body – in our case the European Central Bank in Frankfurt.

Relinquishing a country's sovereignty for a monetary union is by no means a novel phenomenon; in 1867 the UK, France and the USA – the three leading powers of the time – had already contemplated the idea of introducing a single world currency. The idea was soon abandoned as unrealistic. Monetary unions have come and gone on all continents. The four colonies of New England, on the east coast of the current USA, established one in 1750 by recognising each other's currencies. A more noteworthy one was the Latin Monetary Union of the late 19th century, created on France's initiative between the countries of Belgium, Bulgaria, Greece, France, Italy and Switzerland. This franc-zone (somewhat similar to what was in effect the informal deutschmark-zone in the 1960s and '70s), was characterised by the dominance of one strong currency. The Latin Monetary Union (LMU) had a single currency but lacked a common or coordinated monetary policy. Officially the LMU ended in 1926, but its practical significance disappeared long before that as the Anglo-Sax-

on world gradually switched to the so-called gold standard system. The Scandinavian Monetary Union, founded by Denmark, Norway and Sweden in 1873, also proved to be a short-lived experiment. Some monetary unions evolved as nation states emerged, for example that of the Prussian-dominated one created by Bismarck for the North German Confederation and the creation of its customs union (Zollverein). Under pressure from Bismarck, and after full German unification in 1871, Germans using dozens of different currencies accepted the Goldmark as sole legal tender even though the Reichsbank did not have exclusive competence to print money. Bismarck's monetary union was very stable, outliving the Great Depression and two world wars. The reason for its stability was simple: behind the currency was an increasingly unified state. Another, often forgotten monetary union between Belgium and Luxembourg has been in existence since 1921 and was only "overwritten" by the introduction of the euro.

The introduction of the euro was primarily politically motivated, symbolic of the spirit of European unity, with some finer considerations in the background: by pooling their monetary policy competences in a common bank, France and the Netherlands increased their independence from the German Bundesbank, which used to dictate European monetary policy (not by force but rather by market realities). On the other hand, by relinquishing the Bundesbank's hegemony in monetary policy, Germany made a *beau geste* towards European countries (especially France) anxious about its reunification. The symbolic move of giving up the D-mark, one of the most successful currencies of all time, served to demonstrate Germany's European-ness.

Nobel laureate Canadian economist Robert Mundell from 1998 said: "The euro will probably challenge the dominant position of the dollar, making it the single most important development in the international monetary system since World War I, when the dollar took over the pound's role as the leading reserve currency."[1] At this moment this seems like some rather bold statement. The US dollar has twice the share of the euro in currency transactions, and maintains its role as the currency of choice for invoicing in international trade, especially in the oil business. In EU-US trade relations, the dollar is used for settling accounts in 80% of bilateral trade.

2. THE CURRENT ECONOMIC AND POLITICAL FRAMEWORK

Since the euro was introduced, the world economy has undergone major changes, and the trends suggest that the unipolar global monetary system based on the dollar's absolute hegemony is shifting towards a bipolar system. The euro has appeared as a competitor to the dollar. When it was introduced, the euro became the number two reserve currency overnight, and has gradually been gaining in strength as such. All this time, the US economy has accumulated vast debts vis-à-vis the rest of the world (not least China) and has thus weakened astonishingly. The US current account deficit is double (6%) the historic high recorded during the years of the arms race under Reagan in the '80s. The United States has turned from the world's biggest lender to the world's biggest debtor, which shaved off about half of the dollar's value (against the euro) in just a few years.

The international clout of a currency is determined not solely by its role as a reserve currency. A clear indication of the euro's worldwide acceptance is its share in the international bond market (i.e. in the market of non-bank loans), where it already stole the show in early 1999 when – for a brief period – most bonds were issued in euros and not dollars. In the years prior to the euro's introduction, the situation was just the opposite: European currencies struggled to maintain their position, naturally competing against each other, while the dollar gained ground to the detriment of the yen. With the introduction of the euro, the dollar had a new competitor to face, one which has been advancing with giant strides. For non-Eurozone issuers the rule of thumb, however, is the following: when the target investors are European, the bonds are issued in euro, when it is a global issue (including Europe) the dollar is preferred.

Countries with close trading or institutional ties with the Eurozone generally use the euro as their key currency for influencing exchange rates, invoicing and payments (in addition to their own currencies, of course). Lebanon, Egypt and Israel all opted for euro-based loans in the international money market. Nevertheless, on the international scene, the euro still only plays a fundamentally regional role. It serves as a secondary currency in central and South-Eastern Europe and in parts of the Balkans and the Mediterranean, which is only logical as the Deutschmark, and to a lesser extent the Austrian schilling or the French franc, used to play the same role.

Europe is far from being unified, both culturally and economically. Europe's markets are not uniform, which impairs its international clout. However, this is not the main obstacle preventing the euro from becoming the world's leading currency. The real stumbling-block is that it is a currency without a country.

Politics are just as important as economics – if not more important – in positioning a currency on the global scene. Eurozone members are yet to sing from the same hymn sheet internationally, especially at forums such as the G7 or the IMF. The euro is a currency created by politicians but lacking a political image.

Even economic policy strategy is a matter of deep controversy in Europe. The "growth versus balance" question is not unique to Europe; the USA faces the same dilemma. In his essay of 2005[2], Daniel Griswold, research fellow at the Cato Institute, went as far as to argue that, in the light of historic experience, the current accounts imbalance was a precondition to the growth of the US economy. Griswold analysed economic figures from the past two and a half decades and concluded that the growing deficit regularly yielded increased growth and employment. In comparison with the record US deficit of 620 billion, in 2004 Germany accumulated a global surplus of USD 200 million, but with an unemployment rate of over 11%. (The last time the US saw such a high unemployment rate was in 1982, when it had a negligible 5 billion USD deficit.) The USA, as the world's strongest economic power and the holder

1 Posen, S. Adam, ed.: The Euro az Five: Ready for a Global Role? Special Report p18. Washington DC. Institute for International Economics.

2 Daniel Griswold: Bad News on the Trade Deficit Often Means Good News on the Economy. p. 1-3. Free Trade Bulletin, no 14. 14, January 11, 2005.

of the number one global currency, is in many respects in a different position from Europe, especially since Europe is troubled by the peculiar situation of the two arms of economic policy moving to different beats. Monetary policy – i.e. the setting of interest rates (with a direct impact on economic growth and unemployment) – is made in Frankfurt by the European Central Bank, with the governments having no say whatsoever. The strings moving the other arm of economic policy, budgetary policy (i.e. what the state spends money on) are in the hands of the 28 governments. The European Commission is caught in between, trying to coordinate and orientate national budgetary policies by sanctioning member states that overspend and allow their budgetary deficit to exceed 3% of GDP.

How the rules supposed to guarantee fiscal stability in the euro area can be enforced and reinforced is a critical issue. News is regularly coming from Brussels about the stability pact and its bodyguard, the excessive budgetary deficit procedure. This is no coincidence: at any given time as many as a dozen member states – some already in the Eurozone – are in violation of the budget deficit ceiling.

The rules of the stability pact were proposed by Germany, wary of member states with poorer economic track records. Germany had to convince its citizens that the euro would be just as hard a currency as the D-mark was, and would not be jeopardised by other euro area countries under any circumstances. Essentially, the pact is a complex supervisory system to prevent crises through member states constantly keeping an eye on each other, with the excessive deficit procedure acting as a deterrent. The pact was born as a compromise between Germany and France. The Germans managed to realise their pet project and have their pact adopted, but the sanctions (fines) for offenders finally agreed upon were not quite the deterrent originally envisaged. Firstly, sanctions are not automatic, but depend on the discretionary decision of ministers of finance. Secondly, the time until the deposit becomes a fine is so long that it hardly forces governments to make the necessary corrections. Countries afraid of being sanctioned thus have time to explain the reasons behind their deficit and avoid being fined. The sanctions foreseen in the pact have never really been applied in practice; the two big Eurozone economies of France and Germany got off cheap, which largely discredited the pact. People started questioning the point of having the pact and whether its rules could be enforced. The problems surrounding the stability and growth pact are often traced back to the Maastricht convergence criteria, which – for the sake of simplicity and clarity – set objectives that disregarded real economic processes. The key shortcoming of the pact, critics say, is its inability to respond to changing economic circumstances in a flexible manner. This rigidity is most apparent during recession or years of stagnation, when the pact leaves little room for manoeuvre to stimulate the economy as such measures could temporarily increase the budget deficit.

"The euro is nothing more than a system of fixed exchange rates covered by a glossy coat of political paint. The malfunctioning rules of the euro area unite countries that would otherwise be economically incompatible and which could easily be wrecked by a handful of global hedge funds. The luck of the euro is that – for the time being – it is not in the interest of hedge funds to do so".[3] Such views are easy to come across in the European – especially the British – press. The euro will disappear – American financial investors say. Are all of these opinions nonsensical, or is there some truth in it?

Historical experience shows that monetary unions are successful when they have among their members at least one economic power-house acting as the engine. Central institutions are also needed to control and enforce the rules. The most successful ones are preceded by a political union, as in the case of the USA, the UK or Germany. Price and wage flexibility is a fundamental criterion, so that wages can be limited in poorly performing regions, just as inter-regional transfers can be useful. Fixing and applying criteria on economic convergence also prove to be necessary. In the Eurozone, we can hardly talk about real flexibility of labour markets, just as we cannot talk about a political union either. The EU budget is not designed for major income transfers either, as it only disposes of 1% of GDP. The Eurozone meets all of the remaining conditions. The US federal budget is around EUR 3.3 trillion, compared with the EU "federal" budget of roughly 120 billion euros, a good part of which is transferred to non-Eurozone countries. The difference between the internal transfer capabilities of the two monetary unions is obvious. On the other hand, in the absence of a European identity, it is much harder to convince a German factory worker of the benefits of financially supporting Portuguese fishermen than to explain to a Californian why it is important to help the good people of Utah.

One can observe serious shortcomings in the operation of the European monetary union. These are partly caused by the imperfections of the institutional setup, and partly due to the increasing disparities within the euro area in terms of inflation, productivity, and growth rate. (The fact that Spain has accumulated a 9% current account deficit while Germany has a 9% surplus, also speaks volumes.) The gaps are growing, even though they should be diminishing, as we have seen. To make things worse, Europe is losing ground versus the US in terms of competitiveness. Both problems can be traced back to the same roots: the unwillingness of certain member states to carry out the necessary reforms and push ahead with modernisation. Prior to the introduction of the euro, governments were all for reforms as their participation in the single currency was at stake. Italians even had to pay a one-off 'euro levy' and they did not take to the streets in protest. As soon as people had the euro notes in their hands, the purse-strings came loose again. With the disappearance of national currencies depreciation is no longer a monetary policy option; the only instrument governments have at their disposal is to dismantle labour market obstacles and allow competition in all sectors, in other words to strengthen competitiveness through exposure to market forces.

At the time of the creation of the monetary union, it was generally believed that the success of the euro would hinge on two things. First and foremost on the reform of European markets: dismantling the welfare and bureaucratic rules that prevent the economy from unleashing its potential. Secondly, on building stronger political integration. The first is important because countries changing over to the euro lose the option of depreciating their

3 In: Attila Marján: Europe's Destiny, 2010. p. 243

national currency but must remain able to respond flexibly to changes in the world around them. The second is important because a successful stability-oriented economic policy requires social and political legitimacy. When preparing the introduction of the single currency, political union was temporarily taken off the agenda – in order to prevent national governments from exerting political pressure – the Central Bank was given full independence: nobody can just walk into the eurotower in Frankfurt to do a bit of lobbying. As a complementary measure, the stability pact was adopted with the aim of reining in member state overspending. As we can see, the institutional framework is built on mutual distrust: Community institutions without political legitimacy act as the guardians of economic stability vis-à-vis the politically legitimate member states that are not to be trusted. The question is, how long can this arrangement be maintained, when will the steam blow the lid off and who will get scalded when it does? One potential solution – call it an escape route, if you will – is to continue with political integration. But an even more pressing question is, if political integration continues, what will it mean for managing the economies of the eurozone: stability or a spending spree? Despite all of these difficulties, I believe that political integration should not be rushed only for the survival of the monetary union; the euro can wait for slower political integration, but not for slow market integration.

As the world's most powerful banker, US Federal Reserve Chairman Ben Bernanke wrote, "we must accept the Eurozone for what it is: a bold political project, which is not your textbook optimum currency zone, but works nonetheless, and as such cannot be judged by solely economic aspects but as part of the whole European project."[4]

The euro was created by politics – and what a good deed it was. Politics must also help preserve it, but not by taking the easy way out and exercising direct political control over exchange rate policy; instead, focus needs to be on completing internal market integration and agreeing to a higher degree of coordination of member-state economic policies. As André Sapir and Jean Pisani-Ferry put it: the euro area needs fewer routine procedures and more ability to act in times of real crises[5]. The Eurozone's approach to economic changes and political changes (such as enlargement) is still very legalistic, and still has no international strategy and proper representation in fora like the IMF. More profound economic coordination need not mean full harmonisation as that would impair the members' ability to conduct an economic policy best suited to their own conditions and economic cycles. And certainly should not mean the hindering of the Central Bank's functioning, but coordination of structural reforms. The euro is not only an important symbol and an economic stabiliser, but should also be the stepping-stone to more coherent European action on the international scene. It is not only the driving force behind economic integration, but also enhances European identity and reinforces Europe's global role. As Ottmar Issing puts it: *Der Euro* "is still an experiment whose outcome seems likely to remain uncertain for a considerable time to come."[6]

4 In: Attila Marján: Europe's Destiny, 2010. p. 239.
5 Pisani-Ferry, Jean, et al.: Coming of Age: Report on the Euro Area, Bruegel Blueprint 4. p.4. 2008, Brussels
6 Ottmar Issing: Europe: Common Money – Political Union? p. 6. European Central Bank, 1999.

The Eurozone experienced its deepest crisis as from 2008. The European Commission, the European Central Bank and member states had to put in place a series of policy reforms to save the common currency and to get Eurozone economy back on track. It became obvious that the political and economic structure behind the currency union was insufficient and needed a significant overhaul and reinforcement. This recognition helped pave the way to a genuine economic union and gave a new impetus to plans to get closer to a European political union.

3. EUROPEAN ECONOMIC INTEGRATION IN POLITICAL PERSPECTIVE

Economy and politics walk hand in hand in the process of European integration. This has been clearly seen during the years of the euro crisis. During the worst crisis ever experienced by the EU as from 2008, the euro was not seen as the solution, rather than the source of the problem. But in fact, the lesson from the recent malaise is that the policy system behind the common currency needs significant reinforcement.

The euro is one of the most sophisticated results of the process of modern European integration. It is also a symbol of peaceful collaboration between European countries, which has been accompanied by, or has resulted in, unprecedented levels of peace, stability and prosperity in Europe.

In order to restore confidence in the single currency zone, a high-level fiscal union must be created, which will require further measures of economic integration, such as the creation of a European finance minister, a far bigger EU budget, and an effective bank supervisory authority at euro-zone level. Not all members will be able or willing to go that far in the medium term. A two-speed Europe has already come into existence in reality with the UK's decision to stand aside. Nevertheless, the dynamics of integration is uncertain. This is partly because the alliance between the 18 current members of the Eurozone is not a stable formation per se; for many of them, the bar will be set too high, and they will not be able to accept the degree of harmonisation needed. An additional factor is that integration is to proceed on an intergovernmental – rather than supranational – basis, and there will be a need to clarify the roles of the EU bodies, in particular those of the European Commission.

Despite its undoubted successes, modern European integration is – in historical terms – a fragile construct. The main reason for this is the absence of a precise self-definition. Europe is still a nascent formation, consisting of political compromises, a common system of law, a common economic zone, and a collection of political and institutional responses to crises. Although the peoples of Europe have lived side by side for thousands of years, they do not share traditions, living myths, a common identity or language; nor do they project a single image towards the outside world. The political class and the intellectual elite are just as divided: some want more Europe, while others think that even the present level of cooperation is far greater than desirable. The underlying reason is that no one has a clear picture of the function, goal and future development of the EU; there is no agreed vision.

By creating the euro (which was in many – especially in economic – respects either an irresponsible enterprise or a visionary act, depending on one's perspective), Europe crossed

the Rubicon: it pushed integration to a point of no return where it either presses on with a fiscal and political union or must bear the dire economic and social consequences of a break-up of the common currency.

Clearly, the present crisis is one of the most serious ones in the history of European integration. It is fundamentally a political crisis rather than a purely economic one. It is the consequence of a downward spiral of political and economic problems that mutually reinforce each other. At its centre lies a weakness of political vision in the EU and in the Eurozone. In economic terms, Europe is better placed than the USA; yet it is the Eurozone that has become the epicentre of the crisis[7]. History teaches us that monetary unions are unsustainable without political coordination and a fiscal union: a major economic crisis has now made this painfully clear to the Eurozone too.

In the history of European integration, crises have acted as the triggers of major political and institutional changes. Europe and the EU face many external and internal challenges, the scale of which has grown in recent decades (greater international competition, a whole series of demographic, social and budgetary problems). Member states have often made feeble and belated responses to such challenges with delayed reforms and poor management of immigration and demographic trends. At the same time the European Union has not been more robust either (see weak and eventually failed policy visions as the Lisbon programme, diplomatic and geopolitical difficulties due to the lack of a common EU position, years of impasse after the failed European constitutional project, etc.)

The question is whether the present crisis, which threatens the existence of the most important achievement of European integration – the common currency –, will lead to a "quantum leap" towards closer political integration and a multi-speed Europe. It may indeed result in any of the two.

In the medium term, the whole of Europe must prepare itself for a decade of sluggish economic growth. The gap in economic, social and political development within the Eurozone will only widen unless there is a major change of direction in the integration process. In the long term, the European welfare state is unsustainable in its present form (cf. ageing and shrinking populations, budgetary over-extension, an increasing competitive disadvantage vis-à-vis Asia). For this reason alone, it would seem sensible to pool European resources and to aim for a common European political and geopolitical agenda. But that will be the result of economic necessity rather than rationality.

A lot of discussion is taking place about political union. But one thing has to be clear: not any form European political union should or could mean the formation of a regional world government or the elimination of Europe's nation states. The nation state is a European invention, and Europe's nations will never be dissolved into an all-embracing pan-European political unity – if for no other reason than because for Europeans a sense of European identity barely exists, and Europe does not have a common language like the United States does. Political union could mean closer political integration, a real common foreign policy, a real European (or Eurozone) president, real European parliamentary elections, a real (perhaps Eurozone) budget, and a truly common economic policy. It could also mean unified European representation (a single seat and a single voice) in international organisations as well as stronger pan-European symbolism in daily life. The euro would still not be backed by a real country, but there would be regional integration with a far stronger political profile.

Currently, the key question concerning the future of European integration is whether or not a currency without a country is viable. The European Union has tried to establish a monetary union without a political union, but it has become increasingly clear that both are needed – or neither. Some thought that this ambiguous situation would lead to a great crisis, forcing the EU to establish closer political integration. That is to say, what cannot be achieved through nice words, will happen under pressure – as has been the case so many times before. Angela Merkel has a point saying that if the present crisis leads to the end of the euro, this would result in the collapse of European integration as a whole, at least in its present form[8].

Not only is the common currency without a country; it also has no backing in the form of political institutions or even the basic foundations of economic integration. The EU barely has a budget: in a modern market economy, the budget amounts to 40-50 percent of GDP, while the EU budget amounts to just one percent of European GDP. Moreover, money is not spent on things that a "normal" budget would target, but for very different purposes, such as farm subsidies – which still account for almost every second euro spent. These factors add up to a budget ill equipped to make significant transfers between Eurozone members at different levels of development and in different stages of the economic cycle. An even more important deficiency of the Eurozone is its lack of a common economic policy and the cumbersome decision-making with unanimity required, for instance, to adopt common fiscal rules[9].

A closer union in fiscal and economic policy terms – a European finance minister, eurobonds, common financial supervision, and a closely coordinated economic policy – seems inevitable, as does, in certain respects, a political union. All this will require a new treaty, an amended ECB statute, and above all political will. Closer integration may certainly be envisaged in the form of a multi-speed union. A radically different European space is appearing before our very eyes. And in this new space the role of Europe's major powers will change, and there will also be a shift in the relative clout of countries. Germany may be the greatest beneficiary of the reshuffle with its new-found regional primacy. German political elite supports closer integration, which will help mitigate fears of German hegemony, but the German-French tandem will no longer be regarded as a partnership of equals. History (and necessity) has made the economy – and the common currency – the driving force of federalism, rather than political institutional development or the construction of a European cultural identity, which would have favoured the French. The French wanted the euro – and the whole process of integration – as a means of keeping the Germans in check, but in reality

7 Allen, Franklin, et al. *Cross-Border Banking in Europe: Implications for Financial Stability and Macroeconomic Policies*. London: CEPR, 2011.

8 http://www.spiegel.de/international/germany/if-the-euro-fails-europe-fails-merkel-says-eu-must-be-bound-closer-together-a-784953.html

9 Allen, Franklin. *Life in the Eurozone: With or Without Sovereign Default?* Florence: European University Institute, 2011.

the opposite happened. The principles of France's European policy – the multiplication of French power and capacities at the European and global level coupled with categorical intergovernmentalism – have been sorely wounded.

Historically speaking, hostility, rivalries and war are the norm on the European continent; periods of peaceful co-existence are the exception. Also, in historical terms, modern European integration (voluntary cooperation between sovereign states, based on the respect for common laws, and which was launched after World War II with a strengthening of economic and commercial relations but with the primary purpose of pacifying Germany) is a vulnerable formation. As a consequence, peace and solidarity on the European continent may soon be replaced by growing hostility – if the economic situation deteriorates and becomes crisis-ridden in a geopolitical milieu that is increasingly unstable. The fate of the boldest achievement and symbol of EU integration – the common currency – is intertwined with the fate of integration as a whole: an anarchic collapse of the euro would be accompanied by the break-up of the EU and political paralysis in Europe. The euro is fundamentally a political and symbolic creation; in its present form, it does not have firm economic foundations. In light of the above it is in the interest of the EU to save the euro by establishing a strong economic union. With its present architecture, rules and stakeholders (whether they are the EU-28, the EU-26 or the EU-18), the European Union is incapable of moving forward at the right speed and depth. In addition, European public opinion gives a cool reception to any initiative coming from above, from Brussels. The European Union – it seems – faces two possible scenarios in the long term. Under the first scenario, it passively allows the centrifugal forces (markets, member-state sabotage, public disinterest) to break it up or it ceases to exist in its present form, with the unplanned termination of the euro. All of this would be temporarily accompanied by an extremely grave crisis. Under the second scenario, in the extended lands of Charlemagne a new intergovernmental treaty may be adopted, resulting in strong economic policy integration and preserving the euro. The second and third groups of countries could join later based on new conditions (which would be far stricter than they are today). The historical and European lesson is that regional integration projects are far from everlasting, and often the temporary break-up of a poorly designed form of integration is the key to a restructured formation that guarantees long-term survival.