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Why Did Europe Decide to Move to a Single Currency 25 Years Ago?

Many Europeans today inevitably ask the question why the European Community – as it was called a quarter of a century ago – chose the bold strategy of pursuing an Economic and Monetary Union at a time when a number of political and economic issues had not yet been resolved. For someone like myself, who had the privilege of being involved in the early preparatory efforts, the answer is both simpler and more positive as regards the future than most questioners imagine: I believe there was both a strong economic case for moving towards a single currency and a rare political opportunity for implementing it around 1990. Many of my economist colleagues who have been critical from the start think that the economic case for EMU was weak and that the decision was taken strictly on political grounds, hence absolving the economics profession from direct responsibility. That would, in my view, be a misreading of the basis for the decisions at the Intergovernmental Conference, which prepared the Maastricht Treaty throughout 1991. I will start with what I see as the main economic arguments at the time,[1] moving subsequently to the political factors and to some issues that were unresolved or unanticipated in 1990.

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Three main economic arguments

A long economic boom in Europe came to an end with the first energy crisis of 1973-74 – which also ended any hope that Europe could advance towards the monetary and financial integration outlined in the 1970 Werner Report. The European economies then performed poorly with high inflation and low growth for more than a decade. Over the first half of the 1980s, however, progress towards economic stabilisation was observed, and comparisons with the US, Japan and other, more successful parts of the world economy regenerated European ambitions for growth. Momentum in the European debate was restarted by the incoming Delors Commission's initiative in 1985 to

1 For a contemporary assessment, see D. Gros, N. Thygesen: European Monetary Integration – From the European Monetary System to European Monetary Union, London 1992, Longman.

move towards a Single Market in the European Community over the following seven years. A return to the original ambition of monetary integration seemed to many a natural complement to building the Single Market. Obviously, free trade does not presuppose the elimination of national currencies, but there was a perception that it would be unrealistic to pursue the detailed implementation of the 300 or so pieces of legislative initiatives to deepen the Single Market while retaining the possibility of sizeable sudden shifts in competitiveness associated with occasional realignments between European currencies. Large industrial enterprises in Europe strongly supported the perceived complementarity of market and currency unification, pointing to the sizeable expected efficiency gains in their pricing policies and financial strategies.

Acceptance of these arguments went well beyond the ranks of policy makers and industrialists. Organised labour in Germany and elsewhere, keen on assuring a smooth rise in real wages, disliked the uncertainties for wages and jobs associated with shifts in competitiveness due to exchange rate changes vis-à-vis major trading partners. The best protection of real wages would be to constrain exchange rate fluctuations as much as possible.

Some success in this direction had been achieved within the European Monetary System (EMS), which had narrowed exchange rate movements considerably by the late 1980s. After a shaky start in 1979-83, which was generally associated with the policy experiments in the first two years of the Mitterand presidency, convergence of the major macroeconomic indicators, notably price and cost trends, had become observable. This convergence was more advanced in France and several of the smaller member states than it was in Italy or in the three newest member states at the time (Greece, Spain and Portugal), but nonetheless, eliminating exchange rate adjustments among the twelve countries no longer looked totally infeasible over a medium-term horizon.

There was also an external argument in favour of the single currency which commanded broad support among policy makers: the EMS had not protected the participating currencies against the massive disturbances throughout the 1980s that had resulted from swings in the oil price and in the dollar, as the US economy adjusted to monetary tightening and expansionary fiscal policies. When the dollar was weak, the Deutsche Mark (DM) became excessively strong (and vice versa) within the EMS, leading to pressures for realignments that were unwarranted by developments within Europe. In global forums, Germany was increasingly seen as *the* European voice due to its leading role in the EMS, but Germans were becoming less comfortable with this exposure to US criticism and more ready to consider a sharing of the European leadership role with other Europeans.

A third argument played a role in supporting the idea of moving beyond the EMS: orderly management of realignments of central rates had been facilitated by the residual capital controls still in existence in France, Italy and Belgium. However, the Single Market was also designed to create a unified European financial market in which national currencies and the policies underpinning them would be exposed to "market discipline". When the "weaker" economies finally agreed, in June 1988, that they would eliminate restrictions on short-term flows in the near future, Germany (and the Netherlands) acknowledged that the EMS would become more difficult to manage. It was not an accident that two weeks after the decision to scrap residual capital controls by 1990, there was agreement at the Hanover European Council in June 1988 to set up a committee to study how an Economic and Monetary Union with a single currency could be implemented in stages. This committee was named for Commission President Jacques Delors, who was nominated by Germany and France to direct the study. Thus, the financial dimension of the Single Market also helped to clear the path for the single currency.

The above arguments, namely (i) the perception of complementarity to the ongoing Single Market, (ii) the wish to lower the vulnerability of the structure of national currencies to the variety of external disturbances that had been experienced over the preceding decade and a half, and (iii) the realisation that free capital flows within the EU could be better handled by a unified currency area, combined to make a strong economic case for the creation of a single currency. This economic case was generally accepted by both France and Germany, and it was the common basis for a broader compromise on how to proceed; without this economic foundation, we could not have seen an agreement to move towards EMU, no matter how desirable such a move might have seemed on political grounds.

Looking at the three economic arguments with the benefit of hindsight, they still appear largely convincing, even while keeping in mind that a counterfactual analysis of where the EU would be today had it not established the single currency should never be counted as evidence, only as suggestive. Could the Single Market have survived the turmoil of German unification and attacks on the EMS without the prospect of a single currency on the horizon? And would it have been resilient in the face of the financial crisis from 2008 onwards? Surely the answers to both questions have to be much closer to "No" than to

"Yes". Similarly, monetary union has made the participating countries less vulnerable to centrifugal external disturbances than they would have been under even a well-functioning EMS. Finally, eliminating national currencies has reduced the scope for capital flows within the area to drive member states apart, although not to the extent hoped for – as the experiences of the reversibility of such flows between creditor and debtor countries in 2010-12 showed. All in all, the argument that the Maastricht Treaty had no valid economic rationale is highly questionable. I now turn to the "grand political bargain", often seen as the basic motivation for monetary unification.

Was there a grand political bargain at Maastricht?

Many French policy makers – with support from political scientists – are attached to the perception that there was a bargain in which Germany acquiesced in moving towards monetary union and in giving up the DM in return for support from European partners for German reunification. There are two major problems with this interpretation.[2]

First, at the level of principles, there was no basis for a grand bargain. German reunification simply had too much momentum and support where it really mattered – from the US and the Soviet Union – for sceptics such as President Mitterand and Prime Minister Thatcher to block it, or even slow it down.

Second, at the practical level, the principles of monetary union had been designed before the Berlin Wall fell in November 1989 – an event no senior policymaker in Europe had anticipated. The Hanover European Council of June 1988 had laid down the ambition, the Delors Report had fulfilled its mandate to present an outline that showed a feasible approach and the European Council in Madrid of June 1989 had approved the outline.

Still, German reunification may well have had important consequences for the surprising speed with which a single currency was adopted by 11 member states only seven years after the Maastricht Treaty had been signed. Political attention in Germany became absorbed by all the challenges of reunification, which were deemed more significant than those of European integration. The most critical debate over German interests in the project only came long after. German reunification also had a further effect: eroding what had been a major assumption of French and other non-German observers, namely that Germany was about to reach a class of its own in economic strength. The economic impact of reunification was to add a massive burden to German public finances and competitiveness. An external deficit emerged and was only slowly eliminated by 2003, and doubts remained as to whether the economy would ever fully recover its earlier health. Throughout this long adjustment period, relative economic weakness made Germany an advocate of relatively accommodating monetary policies and a softer guardian of orthodoxy – in contrast to what was expected during the Maastricht negotiations.

Thus, Germany was indeed less dominant in the run-up to and in the early years of monetary union – but not because of any grand political bargain. The underlying economics appear, also in this respect, to have been more significant than political considerations.

My tentative conclusions that the idea of a single currency (i) had a solid economic foundation, though one obviously tailored by the experiences of the member states in the 1970s and 1980s, and (ii) evolved in politically propitious circumstances unaided by any grand political bargain, still leave the question of explaining why the longer-term outcome of the initiative has brought many disappointments. Was the construction faulty from the start, notably by focusing narrowly on monetary unification? Or was a basically sound framework abused by divergent behaviour of member states? Or were there omissions, unforeseeable in 1992, that have been left unrepaired since? I shall try to sketch answers to these very broad questions in the following.

Conflicting perceptions and omissions in the Maastricht approach

The demand for monetary union came from France, and to some extent from Italy, with support from the European Commission. Most of the smaller EMS participants were not unhappy with their experience in the EMS; they had converged further to the economic performance of Germany than had France, and they had fewer illusions that a monetary union could eliminate asymmetries due to size discrepancies among the participants, but they were prepared to support a compromise that was acceptable to the two largest member states.

Unfortunately, the way in which that economic compromise was presented to the general public in Germany and in France tended to overwhelmingly emphasise those parts of the compromise that were expected to be especially appealing to the domestic audience. In Germany a single currency was presented as the inheritor of the DM, embodying all the qualities of German economic policies, notably a "stability culture" of low and stable inflation. Not all German officials were convinced that such an outcome had been assured, but they were sufficiently flattered to

2 See also H. James: The Making of Europe's Monetary Union, Princeton, NJ 2012, Princeton University Press.

see their policies and achievements finally, at least implicitly, recognised that they did not oppose the positive line of their government. Such considerations certainly prompted the president of the Bundesbank to sign the Delors Report in 1989.

In France, the idea of the single currency was presented as the way for France to share monetary leadership in Europe with Germany. While the core of truth in this ambition was that the future European Central Bank would eliminate the overt Bundesbank leadership of the past, French policy makers, President Mitterand in particular, failed to mention two inconvenient facts. First, leadership in the new framework would imply an ECB that looked only at the collective, not the national interest. Second, France would be represented by an independent central bank that would not be subject to instructions from the French government. The notion of an independent central bank never appealed to France, and the Banque de France only achieved formal independence in 1993 in preparation for joining the future ECB. More than a decade later, several statements by Presidents Chirac and Sarkozy showed that this evolution had still not been absorbed at the highest political level.

To summarise, if one compares what was said during the French 1992 referendum campaign in support of adoption of the Maastricht Treaty with the explanations of the German government to the German Constitutional Court in 1993 as to why the adoption of a single currency should be regarded as constitutionally admissible, one would wonder whether the two main countries were considering joining the same union. This incongruence of the political perspectives in the two main countries was not only an inauspicious start; it lingered on in the institutional design of EMU and has re-emerged in the conflicts over symmetry vs. asymmetry between debtor and creditor countries two decades later.

Elaborating the basic Maastricht compromise, there was actually much to like in it for both sides, and this could have been presented more positively to the domestic public. France asked for the monetary union it had sought bilaterally for some time – and obtained it at the EU level with the argument that a single currency was a step towards economic and political union, goals that were higher on the German list of priorities. But many details had a primarily German design. Germany failed to convince its European partners to adopt its preferred sequencing in the European unification process, in which monetary union should come last – after or at least only in parallel with political union, as per the formula set out in the Werner Report on EMU two decades earlier. The difficulty for Germany was that neither Chancellor Kohl nor other German officials were able to clarify what political union implied in specific terms; they were convinced, however, that it did not imply fiscal union in the sense of transfers between countries. When pressed, Chancellor Kohl tended to refer to a larger role for the European Parliament and to a sense of common political purpose in areas not directly related to monetary union, notably in meeting external challenges jointly. Maybe these elements remain the best definition available; the former element has progressed, notably with the Lisbon Treaty, but the latter – and essential – element remains elusive and has suffered major setbacks in recent years when the difficulties of generating a common approach to political challenges in several key areas have blocked joint European approaches.

Was the Maastricht approach unworkable – or abused?

What most critics have in mind when they label the monetary union framework as faulty, or at best incomplete, is the absence of elements of a fiscal union. That omission was quite intentional. Not only would it have been politically impossible to agree on any provisions for a fiscal union around 1990, but the economic case for it was generally accepted to be weak. The approach to a single currency in Europe was – and remains – very different from that of large federal countries where the national government has taken over most of the responsibility for economic stabilisation from sub-national levels. In Europe nearly all policy instruments – other than the policy interest rate and the exchange rate associated with the existence of a national currency – were to be left in the hands of member state governments. An extensive freedom for national action was seen as a fair and operational part of a package to deliver monetary stability and eliminate exchange rate uncertainty, while observing the ("subsidiarity") principle that all important non-monetary decisions should be taken as close to national electorates as possible.

There were long and intensive discussions on this framework in the Delors Committee and throughout the protracted Maastricht negotiations. The (optimistic) premise on which the framework builds was that monitoring by markets (aided by governments) would prevent major divergences in economic performances from emerging. Competitive pressures in the Single Market would help keep the evolution of national costs and prices broadly parallel, while financial markets would keep track of the creditworthiness of sovereign borrowers, effectively replacing their evaluations of currency risks (now unnecessary) with evaluations of sovereign credit risks (now of much greater importance).

There was awareness of a major weakness in the latter mechanism: financial markets were seen as likely to be patient for too long and then to suddenly and brutally revise their views.[3] Hence, it was agreed that national governments in the monetary union should be subject to rules for upper limits on public sector deficits and debt and to monitor them in order to underpin long-run sustainability, facilitating a role for market discipline. The outcome was the so-called Excessive Deficit Procedure, which was subsequently made more explicit in terms of procedures and sanctions by the Stability (and Growth) Pact, added in 1997. Both addressed the conduct of national fiscal policies, trying to find a compromise between the role of automatic stabilising mechanisms and longer-term prudence. Efforts by France and others during the Maastricht negotiations to designate a role at the European level for setting an aggregate fiscal stance were ultimately left out of the Treaty – and left out of comments by European officials for almost 25 years, until the ECB President raised them in 2014. The idea of developing a joint fiscal capacity has been given new prominence in the Five Presidents' Report.[4]

The long silence and the disagreements that continue to surround the substance of what constitutes a "fiscal union" show that there remain important disagreements in the perceptions of its core provisions. There is a major difference between the views of those like Germany, who see a need only for rules to constrain nationally divergent behaviour and for collective authority to enforce such rules, and the ambitions of those who want to add an EU-level capacity to set and implement an aggregate fiscal stance. The challenge remains to agree upon whether this second perspective can be taken into account without undermining the disciplinarian perspective by drifting into unduly similar fiscal recommendations for all participants. It is therefore hardly obvious that there was an unnecessary omission in the original framework. Recent practice in monitoring the fiscal rules may have found an uneasy compromise between the two perspectives from Maastricht: the disciplinarian one has become more like a framework for annual negotiations between the participating governments and the Commission than the firm norm originally intended. Furthermore, the interpretation of national situations has been given some flexibility by allowing the overall economic situation in the area as a whole to be taken into consideration.

In another closely related respect, an omission from the framework has been well recognised, but the implementation continues to lag behind. The Treaty focused heavily on *public* sector deficits and debt, not on private sector debt or on overall national imbalances between savings and investment, i.e. on the current account. The obsession with the public sector was understandable, since public debt had risen rapidly in the two decades prior to 1990, and national central banks had, with some success, liberated themselves from obligations to support markets for their own sovereign debt. Current account imbalances were, by contrast, seen as unworthy of separate attention, as long as they were related to an excess of private investment over saving. The very large current account imbalances observed in the run-up to the crisis of 2008 and beyond in countries that met this criterion but whose public finances remained in apparently good order (Ireland and Spain) have prompted an overdue widening of the monitoring perspective. So far, however, this has had limited impact on either surplus or deficit countries. However, the omission is one that was difficult to see at a time when lower capital mobility made the persistence of large current account deficits seem unlikely.

Finally, the restrictive mandate of the ECB reflects the concerns that dominated at the time it was formulated: it was to keep inflation low and stable and protect the coming central bank from pressures to depart from a prudent policy. Such pressures may come from three sources: the rest of the world, the government(s) and the financial sector. The Treaty built up defences against all three. First, the exchange rate of the single currency was to be flexible, liberating the ECB from intervention obligations, effectively giving the ECB a veto on the development of an exchange rate strategy. Second, there were prohibitions on the direct financing of public sector entities and no lender of last resort function vis-à-vis governments to protect monetary policy against the risk of "fiscal dominance". Third, the ECB was to have only an advisory role in financial supervision and an arms-length position in possible rescues of banks and other financial institutions that would require important injections of liquidity. The ECB was to become an exceptionally focused institution, more firmly isolated than other central banks from events that could throw its steady, medium-term monetary policy off course.

On the whole, the design has in my view proven to be more durable than impressions may suggest. One protective mechanism remains intact: currency interventions have been very rare, and the ECB has not had to face serious conflicts between internal and external dimensions of monetary policy. The other two perceived threats to monetary autonomy have materialised. The crippled state of national public finances and the consequent absence of scope for national fiscal policies after the crisis have given the ECB a major role in sustaining demand. This role has

3 See Committee for the Study of Economic and Monetary Union in the European Community: Report on Economic and Monetary Union in the European Community, Luxembourg 1989, Office of Publications of the European Community, paragraph 30.

4 J.-C. Juncker, D. Tusk, J. Dijsselbloem, M. Draghi, M. Schulz: Completing Europe's Economic and Monetary Union, Brussels 2015, European Commission.

been assumed through major purchases of public bonds, but actions which were especially in favour of individual countries have been avoided – an important validation for why the ECB mandate was made restrictive. At the same time, a new institution for crisis management, the European Stability Mechanism (ESM), the need for which was unforeseen under the smooth policy scenario envisaged at Maastricht, was set up in 2012 to take the ECB out of the front line during crises. This step allowed the ECB to announce its Outright Monetary Transactions (OMT) programme, a commitment to purchase sovereign bonds with exceptionally high interest rates – provided the issuer had negotiated an adjustment programme with the ESM. Finally, the ECB has become heavily involved in the supervision of individual financial institutions, as this proved to be the only way in which a single supervisor could be set up. One might take the opening for this institutional solution in the Treaty as a rare example of foresight by the signatories. But the ECB has been to a large extent protected against engaging in major rescue operations partly by higher capital and liquidity requirements for banks and partly by the principle of a "bail-in", i.e. that major losses will be met by the creditors, and possibly the large depositors, of a failing inancial institution.

My main point is that the ECB has preserved most of its strength as an independent central bank, which has been a badly needed asset in the responses to the crisis since 2008. To an even larger extent than foreseen when the Treaty was drafted, the ECB has emerged as the only operational institution at the European level. This is largely a consequence of the inability of the participating countries to agree on the proper use of other, notably fiscal, policies.

Conclusions

This article began by asking the question why it was possible a quarter of a century ago for the then 12 members of the European Community to agree on moving towards a single currency. In contrast to a number of other observers, I argue that there were solid economic arguments and that political bargains played a subsidiary role – but that the political circumstances for implementation were (unusually) propitious in the late 1980s and, particularly, in the 1990s during the run-up to the introduction of the single currency.

There were clear omissions in the framework agreed upon, some deliberate and some due to a lack of foresight that was mostly avoidable. There was excessive optimism regarding the ability or willingness of national governments to accept the constraints of being part of a single currency area and more basic disagreements on what kind of fiscal underpinnings were required. Some of the original omissions have been repaired, though not the fiscal issues. The ECB was set up as a remarkably independent central bank – and it remains so, despite the major role it has taken on in sovereign bond markets and as the single supervisor of Europe's major banks. New features in the institutional set-up have preserved its central monetary role.