

EMU's teenage challenge: what have we learned and can we predict from political science?^{*}

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ABSTRACT We review the initial predictions and claims regarding economic and monetary union (EMU) in Europe against the evidence of its first ten years of existence. We argue that pessimistic views on the creation of EMU have proved to be wrong. Yet EMU's success is rather puzzling, since it is based on a peculiar institutional structure not thought to lead to success. EMU has generated redistributive effects and may have increased business-cycle synchronization. Those effects have not translated into the expected decrease of legitimacy or a widespread democratic deficit of EMU. At the institutional level, EMU has coped well with an asymmetric framework, largely decoupling EMU from political union. There have been neither major spill-over effects pushing for further political integration nor conflict and disintegration. The main question for the future is whether this institutional structure will stay the same in the aftermath of the global financial crisis.

KEY WORDS Economic and monetary integration; economic and monetary union; economic governance; EU politics; fiscal policy; monetary policy; political integration.

INTRODUCTION

Teenage years are always challenging ones. But for economic and monetary union in Europe (EMU) the start of the second decade of its existence could prove to be even more difficult than that. In the face of a major economic crisis, this historically unique economic and institutional endeavour of initially 11, now 16, nations sharing a single currency is threatened in its very existence and will have to demonstrate particular resilience (e.g. *Financial Times* 2009). Is EMU sufficiently strong to face this crisis?

Finding an answer to this question necessitates a backward-looking assessment of the successes and failures of EMU and a forward-looking analysis of the challenges likely to arise. During the run-up to EMU and its early years of existence, research in economics and political science was very active, formulating core predictions and research questions on the basis of conceptual foundations which at that time were mainly analytical, sometimes historical. Today, those predictions can be assessed against the evidence of ten years of EMU and new analytically founded claims can be made on what we expect for the future.

The purpose of this article is to embark on that stock-taking exercise with a particular focus on the findings in political science. While we believe that it is impossible to draw clear disciplinary boundaries in research on a topic that obviously transgresses the realms of politics and economics, we will nonetheless make the attempt to summarize and review critically a certain component of the political science literature which focuses on the nature of the linkage between politics and economics. Therefore, we do include some of the literature that originates outside of political science but which has been discussed at some length in political science for the purpose of our assessment of EMU. We identify three key themes in this research, which we consider to be of particular relevance in the context of the current economic crisis and which we place at the centre of our analysis: (i) questions on the redistributive features of EMU; (ii) questions on the overall legitimacy of EMU; and (iii) questions on the political power structure in EMU. We will first justify the selection of these three themes, before analysing each of them in separate sections, and end by offering a brief conclusion that looks at the implications of the current crisis for the second decade of EMU.

The core claim of this article is that almost all of the highly pessimistic views on the creation of EMU have proven to be wrong. Yet EMU's success is rather puzzling, since it is based on a peculiar mixture of outcomes that no one predicted, and which was not thought to lead to success. We find that EMU has generated redistributive effects and may well have increased rather than decreased business-cycle synchronization. Yet those effects have not translated into the expected decrease of EMU's legitimacy or a widespread democratic deficit of EMU. At the institutional level, we find that EMU has coped well with an asymmetric framework, in which EMU remains largely decoupled from political union. We have not seen spill-over effects fostering further political integration – but nor have we seen conflict and disintegration. The big question for the upcoming decade is whether this peculiar mixture of outcomes will stay the same even in the aftermath of the global financial crisis.

1. POLITICS AND ECONOMICS IN EMU – IS THERE STILL A MISSING LINK?

A key theme in both academic research and practical politics during the run-up to EMU was whether monetary union could be successful in the presence of high economic heterogeneity across the participating countries (non-fulfilment of the 'optimum currency area' criteria: Mundell 1961; Sachs and Sala-i-Martin 1992; Eichengreen 1993) and in the absence of a strong political authority capable of steering the currency union ('asymmetry' between economic and political union: Verdun 1996, 2000; see also Howarth 2007; Jones 2002a; Padoa-Schioppa 2004). Much of the initial discussions therefore rested on the chicken-and-egg issue of whether political union had to precede monetary union or vice versa (for a review of theories concerning the origins of EMU, see Sadeh and Verdun 2009). In political discussions, this issue was most prominently raised in the opposition of the primarily French approach to

monetary union under a *gouvernement économique*, as opposed to the primarily German view that political union had to precede a successful monetary union (Dyson and Featherstone 1999; Verdun 2000; 2003). In the economic literature, a similar issue was discussed in a debate opposing the view that a single currency would create a lower synchronization of business cycles as a consequence of increased specialization in production and therefore an increase in so-called asymmetric, or sector-specific, shocks (Krugman 1993), as opposed to the view summarized under the heading of the 'endogeneity of optimum currency areas', arguing that increased trade integration was likely to create business-cycle convergence in a currency union (see Frankel and Rose 1998).

What came out of those debates in both political science and economics was an arguably gloomy overall picture on the future of EMU. It was based on a few key claims, such as that EMU was in the interest of the largest member states only (Moravcsik 1998); that it could not survive without a common identity of the European citizens (Risse *et al.* 1999); that it would lack legitimacy ('democratic deficit': Majone 1998; Verdun and Christiansen 2000; 2001); that it would end the continental and Scandinavian welfare state models (Leander and Guzzini 1997; Rhodes 1997; see also Scharpf 2002; Hodson and Maher 2002); that it would give rise to numerous collective action problems amongst member states, mainly free-riding in fiscal policy (Eichengreen 1995), and ultimately lead to a weak currency (Cohen 1998) administered by a weak central bank (Gormley and de Haan 1996). Taking all of those points together, the US economist Martin Feldstein famously made the following statement: '[T]he shift to EMU and the political integration that would follow it would be more likely to lead to increased conflicts within Europe and between Europe and the United States' (Feldstein 1997: 61).

With hindsight, it is striking how little understanding or even solidly grounded assumptions there were on the nature of the spill-over effects from the economic side to the political side and vice versa. Instead, many authors offered mere scenarios, sketching out possible domino-effects (such as Feldstein 1997: 61 arguing that in the beginning there would be 'important disagreements among EMU member countries about the goals and methods of monetary policy', which would then be 'exacerbated whenever the business cycle raised unemployment in a particular country'; these disagreements would then trigger 'distrusts among the European nations', and ultimately, 'new conflicts would reflect incompatible expectations about the sharing of power').

Obviously, such scenarios look simplistic – and they are. Indeed, if there is one core message in the preceding list of arguments, it is that the complexity of the various economic, political, and social transmission channels deriving from the single currency is very high. We can easily conclude that none of the many negative scenarios on the future of EMU predicted what really happened.

The goal of scholars of EMU after its first decade should be to take up this complexity, try to assess where assumptions were right or wrong, and then reduce it again to a few updated claims and research questions for the next decade(s). We seek to make a contribution to this discussion.

Our approach is to re-examine the initial discussions on EMU under three broad questions. First, there is the overall question as to whether EMU has triggered redistributive effects amongst member states. This question encompasses several of the points referred to above but can be reduced to a few simple and testable claims. It also allows us to draw clear policy conclusions: if redistribution takes place, there are good reasons to allow for rebalancing activities. Various suggestions have been made about how to achieve them (ranging from fully-fledged fiscal federalism to rebalancing activities via the European Union (EU) budget). The second key question is, what is the appropriate type of legitimacy for EMU? Pareto-improving policies, i.e. policies that improve overall aggregate welfare without making anyone worse off, can generally be legitimized on the basis of their result only ('output legitimacy'; e.g. Scharpf 1999), whereas welfare distributing policies either require a direct type of procedural legitimacy ('input legitimacy') or a very strong collective normative basis (often a common national identity). Finally, our third main question is, what is the power structure in the politics of EMU? Do member states only act on their direct interest (Moravcsik 1998) or has EMU given rise to independent actors or mechanisms working not only in the direct interest of the largest shareholders in the system but also maximizing collective utility. This question obviously touches upon the roles of the European Central Bank (ECB), the EU Commission and the Eurogroup; it also asks whether spill-over effects in typical neo-functionalist fashion have started to materialize.

2. WELFARE EFFECTS OF EMU: EFFICIENCY INCREASES VS. REDISTRIBUTION

Every monetary union that is far removed from being an 'optimum currency area' will at one point face the challenge of its own distributive implications, calling for some kind of rebalancing through redistribution (Mundell 1961; McKinnon 1963; Kenen 1969). Economic historians give several accounts of how the trade-off between preserving monetary union and preserving national cohesion ended in the break-up of a previously politically integrated area, even though one has to acknowledge that the causes of the break-up of national monetary unions are typically found in political developments rather than in purely economic forces (see Bordo and Jonung 2003 for an overview). In EMU we can differentiate between three main channels of welfare or redistribution effects. The first channel is the overall welfare generating effect from a single currency; the second is the redistribution effect emerging when there is a primacy of the real interest effect over the real exchange rate effect; the third is a redistribution effect from welfare state policies and possible retrenchment as a consequence of EMU.

Welfare enhancing effects

First, EMU has certainly triggered some welfare generating effects. Not surprisingly, the most complete summary of those positive effects can be found in the Report of

the EU Commission email: 'EMU@10' (EU Commission 2008). In this report, the main emphasis is put on (i) the successes of monetary policy in anchoring inflation expectations, (ii) progress in fiscal consolidation in EMU member states, (iii) economic and market integration in the euro area, (iv) financial market integration, (v) resilience against external shocks, (vi) accelerated catching-up processes in lesser developed member states, (vii) the success of the euro as an international currency and the euro area as an integrated 'pole of stability' in the world economy, and (viii) job creation with employment in the euro area having increased by 15 per cent since the creation of the euro.

Whether all of those effects can be causally linked to the creation of EMU is of no crucial importance for our assessment. There are various welfare enhancing effects that at least partly confirm the high expectations that were voiced in the run-up to EMU, mainly in the 'Delors Report' (1989; see also Commission of the European Communities 1990, 1991), even if the EU Commission in current assessment puts much less emphasis on trade creation than in its *ex ante* justifications of the creation of a single currency.

Redistribution as a consequence of the real interest rate

Besides welfare enhancing effects there is also increasing evidence that EMU has generated welfare distributing effects. The EU Commission itself acknowledges such effects (2008: chs 1–4), even if the wording chosen in the report is careful, probably because of the Commission's awareness of the consequences that such effects might trigger; see below.

The key mechanism behind welfare distribution in a currency union is the primacy of the real interest rate effect over the real exchange rate effect. As the ECB does not take into account economic developments in single member states but rather targets the euro area as a whole, its 'one size fits all' monetary policy may destabilize those domestic cycles whose economic fundamentals are not in line with the euro area average. Member states with higher inflation rates than the euro area average face low real interest rates generating higher rates of investment and consumption. These effects drive up the domestic growth rate beyond its long-term potential, thereby generating even higher inflation rates, further reducing real interest rates, and ultimately generating cyclical overshooting and price bubbles. Similarly, in a context of low inflation and high real interest rates, growth rates are likely to fall below potential growth, thus triggering even higher real interest rates and potentially generating a textbook-type bust cycle.

Prior to the start of EMU, most theoretical analyses of monetary unions assumed that the real exchange rate effect would have primacy over the real interest effect and that domestic stabilization would therefore be generated automatically (Frankel and Rose 1998). This approach was built on the assumption that domestic prices (and thus also real interest rates) in a monetary union are bound to converge given the mobility of goods and services in the internal market. In EMU, however, a significant share of domestic output derives from so-called 'spatially fixed factors', such as real estate and heavy machinery,

which are not affected by direct price competition (Maclennan *et al.* 1998). Moreover, regional economic adjustments based on real exchange differentials take a significant amount of time.

As first evidence from the past decade indicates, the relevant economic fundamentals in most euro area economies have tended to diverge. Looking at cross-country differences in the two crucial elements for the conduct of monetary policy – the inflation rate and the output gap – one can see that there were persistent differentials that generated at least some kind of redistributive effects. The ECB has published two main studies on inflation differentials (ECB 2003, 2005) and explicitly notes that ‘inflation differentials in the euro area appear to be very persistent’ (ECB 2005: 63). During much of the decade, member states such as Greece, Ireland, the Netherlands and Spain experienced significantly higher inflation rates than the euro area average. Most of them have also grown above potential. Of course, the situation of higher inflation has a dynamic effect of reducing the competitiveness of that country and therefore in principle in the long run works as an automatic stabilizer. Germany, by contrast, has had the lowest inflation and highest real interest rates, while remaining far below its potential growth rate. Again, low German prices would eventually be able to benefit the competitiveness of German products in the export markets even if not immediately. Overall, there is an intriguing positive relationship with a fit of roughly 0.5 between average deviations from euro area inflation and average deviations from the euro area output gap in the first years of EMU (Deroose *et al.* 2004: 10). The International Monetary Fund (IMF) (2004) also finds initial evidence for the primacy of the real interest rate effect over the real exchange rate effect.

The relationship between the real interest rate effect and the real exchange rate effect has crucial implications for the institutional set-up of EMU and also for the analysis of EMU's legitimacy (Enderlein 2006a). If the primacy of the real interest rate over the real exchange rate is a structural feature of EMU, as seems to be the case in the first decade of EMU, it is quite likely that in the euro area there will be a trend towards cyclical divergence instead of convergence. Ultimately, there could be a risk that EMU splits into two equally sized groups of countries, one with high growth and high inflation rates, the other with low growth and low inflation rates, with the ECB targeting a zero growth and zero inflation average in the middle. This scenario may become even more likely as new EU members join EMU. In such a context, the ECB's monetary policy would be inappropriate for all EMU members. As such, this would not generate insurmountable problems, however. As ECB President Duisenberg noted as early as September 1999: ‘A single currency does not call for uniform wage developments or uniform economic or social policies in general. On the contrary – where national or regional economic developments are different, this should be reflected in different policy responses and wage developments’ (ECB 1999). In other words, fiscal policy and wage-setting should be in charge of stabilizing the domestic business cycle, thus strengthening the role of domestic economic policies in EMU, rather than weakening them.

Most of the evidence suggests that EMU has triggered redistributive effects and that member state economic policies have responded with specific national answers (see Enderlein 2006b for a review of domestic adjustments). Rather than triggering further integration and synchronization of business cycles, EMU seems to have triggered diversion.

Redistribution as a consequence of welfare state adjustment

Would EMU be influencing member states' capacity to determine their own welfare state policies? Since EMU needs to be built on a strongly integrated internal market, national economic policies cannot freely choose their preferred domestic approach but have to adjust to significant regulatory pressure deriving from economic and monetary integration. Scharpf (2002: 648; italics in original) observes that 'compared to the repertoire of policy choices that was available two or three decades ago, European *legal* constraints have greatly reduced the capacity of national governments to influence growth and employment in the economies for whose performances they are politically accountable.'

Many authors who were writing on globalization and 'neo-liberalism' argued that the welfare state itself was at risk. The fear was that there would be a race to the bottom in terms of public expenditure on welfare states as a result of two mechanisms. First, competition between member states for investment would drive taxes down (thus generating fewer state revenues). Second, the same pressures would also drive social security premiums down so as to ensure that employers were not paying too much in non-wage costs that affected their cost structure. The result was a prediction that EMU would cause welfare state retrenchment (Leander and Guzzini 1997; Rhodes 1997). However, the creation of EMU has reduced the costs of servicing the debt. Interest rates on public debt have come down and effectively created more financial space for public spending.¹

Tolga Bolukbasi (2007, 2009) suggests that although most of the literature supported the claim that EMU will lead to welfare retrenchment (and that this literature mostly felt this was a 'bad' development), the actual empirical studies of the amount of money spent on welfare state expenses throughout Europe in the past decade indicate that this amount has gone up rather than down. In other words, it is difficult to find support for the claim made by that literature. The debt servicing matter aside, it could, of course, very well be that the counterfactual (how much would governments have spent on welfare state expenditure *without* EMU?) could have been more. But the fact is that, despite EMU, welfare state expenditure did not go down. Also, the quality of expenditure and of the welfare state does not appear to have been reduced by all that much (if at all). There have been some changes in the allocation of funds in welfare states but some of those reallocations had to do with cost control in an environment that requires higher expenditure because of the ageing population, and so on. In other words, we cannot find support for the claim that EMU caused welfare state retrenchment in the sense that it

undermined states' capacity to have a welfare state of their liking. What is, however, an effect of EMU is the fact that it is cheaper for governments to borrow money than it was before EMU.

Summing up, EMU has increased overall welfare; it has triggered redistributive effects via the real interest rate channel, but welfare state retrenchment has not taken place. What are the implications of this combination of effects? A monetary union has to strike a balance between considerations of union-wide efficiency and legitimacy (Sadeh *et al.* 2007). Obviously, that balance is more easily reached in an optimum currency area, where establishing a monetary union is a pure Pareto improvement and does not generate any redistributive implications. However, as soon as efficiency-increasing policies generate spill-overs of a redistributive nature, striking the balance between efficiency and legitimacy becomes more difficult (Eichengreen 1990).

3. EMU'S LEGITIMACY: WHAT HAVE WE LEARNED ABOUT THE DEMOCRATIC DEFICIT?

EMU's technical and institutional achievements are merely the necessary condition for its overall success. The sufficient condition implies a widespread acceptance of the implications triggered by EMU. Therefore, given the close functional links between different economic instruments, the spill-over effects discussed in the previous sections are likely to have an impact on EMU's legitimacy. If it was confirmed that business-cycle convergence is indeed tending to increase rather than decrease, the current EMU framework and its underlying provisions on legitimacy should be reassessed. In particular, new thought would have to be given to the future of the fiscal framework and to the possibility of preserving different social and employment models that currently coexist within the euro area.

The analysis of the 'democratic deficit' of EMU had started even before the euro was introduced and the ECB established (Jones 2002b; Verdun 1998). After a strong focus on the ECB itself, scholarly focus on legitimacy issues in EMU spread out to the institutional features of EMU as a whole (mainly discussing the question of the need for a *gouvernement économique* (Dyson 1994; Howarth 2001; Verdun 1996, 2000) before touching upon connected areas such as the Stability and Growth Pact (Collignon 2004; Heipertz and Verdun 2004, 2010; Howarth 2004; Savage and Verdun 2007), the open method of co-ordination and the Lisbon Strategy (Hodson and Maher 2001; Scharpf 2002), and the EU budget (Enderlein *et al.* 2005). We now briefly review the discussions on the ECB and the overall institutional framework.

The legitimacy of the ECB

In the early discussions on the design of the ECB, various authors argued that economic policy might fall victim to lack of speedy and effective co-ordination (Dyson 1994; Johnson 1994; Verdun 2000). Their argument was that with the

creation of a supranational monetary authority but no transfer of sovereignty over fiscal policy, in case of difficulty, monetary policy could be easily conducted effectively, but not so fiscal policy.

The first ten years of EMU have shown the ECB to be very predictable about its policies. Many observers have taken the line that the ECB is 'secretive', 'slow', unnecessarily lacking 'flexibility' (Howarth and Loedel 2005). The point that the Governing Council of the ECB has tried to make, however, is that it needed to be predictable and that way build up credibility (De Haan *et al.* 2004). The overarching strategy to meet its mandate to preserve price stability was to anchor price expectations. As such, the ECB's assessment of its own legitimacy has been entirely on 'output legitimacy'. Looking at the assessment of the euro and the ECB's role in the first decade of EMU, the results are positive (Banducci *et al.* 2009).

Moreover, the intensity of the debates surrounding the ECB has significantly decreased in the course of the past decade. The main reason may be that the democratic structure underlying the ECB's role is being better understood: the ECB has been given a democratic mandate through democratically mandated procedures and bodies (national referenda, national parliaments, and indirectly through national government); the ECB statutes are part of the EU Treaty structure and thus signed by heads of state and government and ratified by parliaments. The mandate is clear, hierarchically structured and transparent. Monetary policy is geared towards the maintenance of price stability (the support of the general economic policies of the Community being only possible if the outcome is 'without prejudice to the objective of price stability', Treaty Establishing the European Community (TEC) Art. 105(1)) and thus leaves little room for policy discretion.

The above assessment confirms what Majone (1998) and others have shown: the ECB has been granted a mandate much like that of a constitutional court or an independent regulatory agency. The mandate can be changed if it is deemed inappropriate. Also, the ECB itself has developed a comprehensive system of channels of communication and practices of accountability (Jabko 2003).

In short, even if voices occasionally refer to the need for a *gouvernement économique* or changes to the ECB's mandate, no real discussion on this issue has emerged over the past decade. Numerous occasions, on which the statutes could have been changed (the Treaties of Amsterdam and Nice, the Treaty Establishing a Constitution for Europe and the Lisbon Treaty), did not even generate a discussion on the ECB, its mandate and statute.

The legitimacy of EMU's institutional design

When EMU was designed, it followed an incremental path of European economic integration that had been developing for decades. EMU firmed up the concrete basis that had been established during the 1980s through the European Monetary System (EMS), the single market project and incremental integration in various areas of policy-making. What it did not achieve, however, was to

introduce a fully-fledged federal-like system. In the 1970s there had been various studies done about the need for fiscal federalism in the EU, such as the 1975 Tindemans Report and the 1977 MacDougall Report (Verdun 2000). In other words, by the late 1980s and early 1990s although the creation of a European System of Central Banks and a European Central Bank, modelled after the successful German central bank, the Bundesbank, was envisaged, the plan to create EMU in three stages did not envisage simultaneously the creation of a federal-like economic authority. In other words, the design of EMU was 'asymmetrical' (Verdun 1996, 2000).

This asymmetry did not produce a democratic deficit, however. There is now a solid common understanding of the nature of the present framework and its provisions on legitimacy. In the Maastricht Treaty, EMU is described as a rather rigid legal construction gearing at specific objectives, on which societal preferences have largely converged. Price stability and the soundness of fiscal policies are considered as the constitutive pillars of the framework and enshrined with comparatively great detail in the Treaty and primary legislation, thus enjoying significant isolation from direct policy input (Gormley and de Haan 1996). As stated above, the ECB's mandate is solidly anchored in the policy preferences of EMU participants (Kaltenthaler 2006). In a similar vein, the legal framework on fiscal policy co-ordination, as set out in the Stability and Growth Pact (SGP) and the Excessive Deficit Procedure (EDP), is focused on sustainability issues ('close to balance or in surplus', Council Regulations 1466/97 and 1467/97) rather than on welfare consequences of fiscal stances and their inter-temporal implications (e.g. Fatás and Mihov 2003). Many analyses also point to the normative origins of that approach as the emulation of the widely respected German case and its conceptual groundings in a certain understanding of economics (e.g. Dyson and Featherstone 1999; McNamara 1998).

The legitimacy of this framework clearly derives from the efficiency increases or welfare-enhancing components of EMU. In this perspective, monetary policy (often quoted together with competition policy) is interpreted as the area of economic governance that in basically every advanced industrial economy enjoys insulation from direct political contestation. Delegating this task to the European level should thus be considered as legitimate as keeping it in the national realm. In theoretical terms, the particular nature of monetary policy as a functionally clearly delimited task geared towards the objective of price stability justifies the exclusive focus of legitimacy provisions on the output side (Verdun 1998), even though the typical problems deriving from such a principal-agent set-up are likely to arise (Elgie 2002). The ECB frequently uses this line of argumentation pointing out that it has been entrusted with the task of pursuing a commonly agreed goal that does not hamper member states' own policy choices (ECB 2001, 2002). Though member states are generally obliged to consider their economic policies as a 'matter of common concern' (TEC Article 107), they enjoy sufficient room for manoeuvre to follow citizens' policy inputs, thus complementing the output legitimacy dimension of monetary policy with an input dimension in the other areas.

Quite strikingly, this innovative design of structures of legitimacy has not translated into a 'democratic deficit' of EMU, even though the redistributive consequences of EMU are larger than expected (see above). Obviously, the issue of redistribution is likely to have an important impact on the question of the appropriate type of legitimacy. Pareto-improving policies can generally be legitimized on the basis of their result only ('output legitimacy'). Welfare distributing policies, on the other hand, either require a direct type of procedural legitimacy ('input legitimacy') or a very strong collective normative basis (often a common national identity) establishing the readiness of all participants to comply with the redistributive implications of an output-oriented type of policy (one example from national politics is unemployment insurance; in the European context one could think about fiscal federalism or redistribution via the EU budget).

In the EU, the degree of collective acceptance of possible redistributive implications of EMU is arguably quite low, in particular if one takes into account that such redistribution can hardly be justified as deriving from direct political input and thus bears the risk of being perceived as illegitimate. So it is puzzling to conclude that EMU's legitimacy seems to be solid, although redistributive effects are stronger than expected. If anything, this reconfirms the *sui generis* character of EMU and the difficulty of applying benchmarks from national contexts to the assessment of EMU.

3. EMU'S POWER STRUCTURE – IS FURTHER POLITICAL INTEGRATION NECESSARY?

EMU's institutional framework has also often been labelled as a *sui generis* construction. The puzzling results on the questions of redistribution and legitimacy ultimately also raise the question on the allocation of decision-taking powers in EMU and thus on the overall allocation of power. The claim by some observers that EMU had been built by utility-maximizing power-players (cf. Moravcsik 1998) implies that further political integration would either have to increase the power position of those actors or at least not take place at their expense. At the other extreme, one could have expected to see the emergence of truly European institutions and agenda-setters, slowly contributing to the emergence of a *gouvernement économique*. Neither of the two expectations proves right: after the first ten years of EMU, there is an abundance of views on how much political integration may be necessary to keep EMU sustainable in the long run; yet the system looks stable.

Assessing the overall institutional set-up of EMU, we have witnessed the consolidation of the EMU framework that, at the time it was conceived, many observers found odd, or unlikely to be stable (e.g. Cohen 1998: ch. 4; Feldstein 1997; McNamara 1998; McKay 1999). The peculiar mixture of national and European interests across formal, semi-formal and informal bodies and fora has seemed to work just fine (see Hodson 2009). The Eurogroup – the group of finance ministers from the euro area countries – meets before the Economic

and Financial Affairs (Ecofin) Council meeting and seeks to co-ordinate fiscal policy in a rather secretive and very informal framework (there is not even a formal protocol). So the informal network has been strengthened, although many observers had feared that informal rules in EMU would lead to conflict.

At the European level, we have seen the ECB developing into an unexpectedly strong and autonomous European player, completely neglecting national concerns. The ECB has resisted criticism of its mandate, but has shown some flexibility in adjusting (and improving) its initial two-pillar strategy and has successfully responded to criticism on its provisions on transparency and accountability (Jabko 2003). At the same time, the ECB has been much less successful in strengthening its position as the worldwide voice of the euro. The external representation of EMU still looks as messy as a decade ago. The European Commission's role in supervising the institutional framework of EMU has been of mixed success. While it managed to keep the common fiscal framework pretty much alive (see below), it has certainly not managed to take on a leading autonomous co-ordinating role in economic policy-making. A ranking of the importance of the three key individuals in the management of the euro area would put the EU's Commissioner for Economic and Financial Affairs clearly behind the ECB President and the President of the Eurogroup.

Looking at fiscal policies, we have seen that the half-institutionalized framework that was so aggressively criticized might have crumbled, but did not fall apart. The French and German governments might have managed to interrupt the rules of the EDP of the SGP and buy themselves time. But ultimately, the discussions of November 2003 and the reform of 2005 had a surprisingly stabilizing effect on the overall framework. If anything, by 2007 it seemed that most countries had accepted the broader SGP regime and were incorporating in their daily business the medium-term objectives and the reference values for excessive deficits (Heipertz and Verdun 2010). Moreover, even the most critical observers must admit that financial markets cared much less about fiscal free-riding than many had assumed (Leblond 2006). Also, financial markets did not respond much to the fiscal profligacy of member states in the run-up to the SGP crisis of November 2003 or in its immediate aftermath. Moreover, fiscal free-riding and excessive deficits in the largest member states had no immediate impact on ECB monetary policy, despite the fear of a game of 'chicken' arising between fiscal and monetary policy authorities and vague ECB threats that it would (Howarth and Loedel 2005). Until the recent global financial crisis the yield spreads on euro-denominated government bonds of euro member states narrowed.

Yet another result emerges from the assessment of economic policy co-ordination. We have seen that EMU actually brought about a small renaissance of domestic economic policy-making rather than generating widespread co-ordination of economic policies in EMU (Enderlein 2006b). This room for manoeuvre was possible in part due to the safety-net provided by EMU; financial markets could no longer respond to these policies by targeting the country's exchange rate if economic policies were not in line with market

expectation (as was the case in the early 1980s when there was a run on the French franc following the policies of Mitterrand; or the difficult position Denmark and Sweden are in today following the fall-out of the global financial market of autumn 2008). Indeed, EMU member states have experienced that there are good reasons to preserve a high degree of national autonomy in fiscal policy to act counter-cyclically in an asymmetric downturn (fiscal consolidation indeed took place during cyclical upswings). And wage-setting was chosen by several countries as an instrument to fight domestic inflation or to increase competitiveness within EMU (see Johnston and Hancké 2009; also Enderlein 2006b).

As a conclusion, and perhaps most surprisingly, this strange mixture of contradicting results on political integration has not led to an overall weakening of EMU. Most observers refer to EMU as a success, even though today's features of EMU probably do not correspond to what critics or proponents had in mind 10 to 15 years ago. So the assessment that EMU would become unstable without further institutional change in the area of political union or without more centralization of economic government did not seem to be a necessary condition, at least based on the experience of the first ten years of EMU.²

4. CONCLUSION AND OUTLOOK: EMU IN THE GLOBAL FINANCIAL CRISIS

The first decade of EMU has shown that the risks envisaged by critics did not materialize in any serious way. Yet EMU's success story does not follow the plot of a slick screenplay either. The first ten years have resulted in a strange mixture of outcomes, which do not correspond to any of the many causal chains identified by its critics. EMU is generating welfare distributing effects, yet its legitimacy is strong and the innovative or peculiar institutional framework is functioning quite well. Thus, we draw the main conclusion that EMU has strengthened its *sui generis* character and might continue to do so in the coming years. Having said this, the big question for the next decade is whether this peculiar mixture of outcomes will stay the same even in the context of the global financial crisis.

Looking at current developments, one can identify three main reasons why the financial crisis might negatively affect EMU's success story. First, the economic downturn could have an effect on EMU's legitimacy – accepting redistributive effects in good times is much easier than in bad times. Second, the rapidly worsening fiscal position of many euro area member countries could put significant strain on the common fiscal framework – ultimately, even a sovereign default in the euro area cannot be completely excluded. Having said that, to date, countries within EMU have fared better in the financial crisis than those outside. Third, national utility maximization might well resurface, giving rise to concepts that were about to disappear, such as protectionism, the support of domestic industries and the financial sector with subsidies, beggar-thy-neighbour wage and tax policies, and the like.

The financial crisis could also have positive effects. First, the ECB, the euro, EMU even with its fiscal regime, could emerge strengthened (Heipertz and Verdun 2010). Depending on how the crisis management continues, Europeans might look at EMU as a safety net in the crisis. Second, the EU's still chaotic framework of banking regulation and supervision could finally become more centralized, thus giving rise to further integration in financial markets (see Quaglia 2009). Such a move would definitely strengthen EMU. Third, the crisis could foster co-ordination of domestic economic policies. Even though the Franco-German dissent in the autumn of 2008 on how to react to the crisis referred back to the run-up to EMU, the widely acknowledged successes of the French Presidency of the EU in managing the crisis could give rise to calls for further integration and centralization.

EMU as a teenager looks very different to what we expected at its birth. But we are confident that it will meet the challenge of its teenage years. We have to acknowledge that the linkages between the economic mechanisms at work in EMU and the political setting, in which they are embedded, are still not as well understood as we would like. The '*sui generis* question', i.e. the question as to whether a monetary union can operate successfully in the absence of a highly integrated political union, is still awaiting a clear answer. The financial crisis is the first major test of EMU's teenage years, but it is as much a challenge as an opportunity. If EMU manages to cope with this enormous challenge, it will likely have an easier life as an adult.

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NOTES

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1 We are grateful to Erik Jones for reminding us of this point.

2 Of course, some observers argued that even though EMU was not designed according to the textbook, the specific European model might make it robust in the long run. Jones (2002a) argued that EMU's diversity was a strength and not a weakness and that efforts to centralize authority would be more destabilizing than stabilizing; Verdun (2000) argued that there was no support for further economic and political integration to accompany the creation of EMU in the late 1990s, and that a crisis would be needed to make any next steps politically desirable and acceptable. We will see what the future brings.

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