‘Whatever it takes’: The Eurozone Crisis as a Catalyst of European Integration

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Abstract

There are two levels to the Eurozone crisis. At a more fundamental level, it is a crisis of capitalism spawned by a secular decline in profitability that has given rise to growing indebtedness in the advanced capitalist countries. But the shape that this crisis takes is determined by the European Union’s political configuration, more precisely by the institutional imbalance between a centralised monetary policy and decentralised fiscal policies. This article traces the cause of this imbalance, through a brief examination of the political history of Europe’s monetary union, to the strategic ambivalence of France’s European policy. It concludes by arguing that the current crisis has created political conditions that should push French elites to reconsider their hostility to a more centralised fiscal policy framework for the Eurozone.

Keywords: political economy, monetary history, European integration

Introduction

The Eurozone crisis has been in abeyance for more than a year now, ever since the president of the European Central Bank, Mario Draghi, pledged to ‘do whatever it takes’ to save the euro. That statement is part of a broader deal struck sometime during the summer of 2012 between the main players involved in the handling of the Eurozone crisis, that is the German and French governments, the European Commission and the European Central Bank (ECB). The deal involves on the part of the ECB the explicit pledge already mentioned in exchange for a commitment by embattled Eurozone states (including France) to ‘do their homework’ by imposing fiscal consolidation (austerity) and structural reforms. The ECB’s pledge aims to diminish the intensity of financial speculation, thus buying time for governments that have accepted the structural adjustment agenda pushed by Germany and other North European states as the solution to the Eurozone crisis. It is also intended as a clear signal to financial investors that they can invest in South Europe again.

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What has really been in abeyance is speculation on financial markets fuelled by the perceived risk that the Eurozone might not survive the crisis in one piece,[1] namely, that one or more member states might withdraw from the monetary union and reintroduce their own national currency. Once it was made explicit that that risk did not exist, speculators – especially American hedge funds – decided it was safe again to invest in such things as South European sovereign and corporate debt and accordingly ploughed their money back into what has come to be called the Eurozone periphery.[2] But the deep structural features that make up the Eurozone crisis are still present and it will take some time for them to go away.

There are two levels to the Eurozone crisis. One is that the Eurozone crisis, to borrow from economist Michael Roberts, 'is a crisis of capitalism, not the euro'.[3] More precisely, it is a crisis of the advanced capitalist economies (the European Union (EU), North America and Japan) whose root cause is the secular decline in the average rate of profit starting in the seventies. Declining profitability has led to declining rates of investment and hence a slowing down in productivity growth. Firms and governments have attempted to restore profitability by squeezing wages. That strategy has, however, triggered a massive rise in indebtedness, both public and private. Rising indebtedness has, in turn, fuelled a number of speculative bubbles that periodically burst, the worst of which did so in 2007, thus triggering the economic crisis that readers are familiar with.[4] States have had to step in every time, as they did in 2008, to prevent a deep plunge into depression, either through so-called 'automatic stabilisers' or direct interventions to bail out bankrupt firms. The result has been a huge build-up in sovereign debt (in the case of Japan that debt now stands above 210% of GDP). This is the fundamental backdrop to the current 'sovereign debt crisis' that emerged in the wake of the Great Recession of 2008–2009 and that, in different ways, afflicts both the Eurozone and the United States federal government.

The different shapes in which the sovereign debt crisis manifests itself in the United States (US) and the Eurozone points to the second structural feature of the Eurozone crisis. In the US, most public debt is held by the federal government as opposed to the States governments. That

1 I write 'perceived risk' partly because my own analysis is that such a risk never did actually exist. Draghi's pledge merely made explicit a commitment that should never really have been in doubt. For an extended take on the issue arguing this case, see C.F. Bergsten, and J. Kirkegaard (January 2012) 'The Coming Resolution of the European Crisis', Peterson Institute for International Economics policy brief 12-1.

2 R. Atkins, A. Ross, A. and M. Stothard (2013) 'Euro Periphery Draws Back €100bn', *Financial Times*, 28 January 2013 and R Atkins (2013) 'Eurozone Stocks Shed Country Risk Burden', *Financial Times*, 9 September 2013.

3 M. Roberts (2013) 'Workers, Punks and the Euro Crisis', post on Michael Roberts Blog, 16 March. The post is based on a long talk given by the author at the Institute of Labour Studies in Slovenia. The talk can be viewed at: [https://www.youtube.com/watch?v=IaWHNaSRzmY].

4 For a few examples of this analysis, see R. Brenner (2009) 'What is Good for Goldman Sachs is Good for America. The Origins of the Current Crisis', Center for Social Theory and Comparative History, University of California, Los Angeles (UCLA); A. Kliman (2011) *The Failure of Capitalist Production*, London: Pluto Press. This is also Roberts' analysis as it applies to the Eurozone in the talk referred to above.

reflects the much greater degree of political centralisation that obtains in the US as opposed to the EU. Accordingly, the sovereign debt crisis in the US has taken the shape of a political crisis in Washington DC, pitting Republicans against Democrats. In the Eurozone, sovereign debt is exclusively held by the member states. Fiscal policy is almost entirely decentralised, despite the fact that monetary policy has for the most part been centralised. Thus, the sovereign debt crisis in Europe has selectively hit the weakest governments and been characterised by a strong polarisation between North European states, perceived to be creditworthy by financial investors, and South European states. Interest rates on the sovereign bonds of the two groups of countries widened dramatically during the crisis and capital fled the South for the safe haven of the North. South European banks, an important part of whose assets is made up of the bonds issued by their own governments, have been weakened accordingly and have found it increasingly difficult and costly to refinance themselves through the capital market. As the cost of refinancing themselves has soared, they have raised interest rates on the loans they provide to their domestic economies. The resulting credit crunch has held back economic recovery in Southern European countries. As a consequence the Eurozone has proven to be much more financially fragile than the US.

What actually separates North from South European Eurozone member states is not geography (Ireland is part of the latter) but external competitiveness. Since the introduction of the euro in the late nineties, macroeconomic imbalances have built up between the two groups of countries.[5] Germany and other North European countries have been accumulating trade surpluses and France and other South European countries deficits. This means that the deficit countries need to borrow from abroad to finance those deficits. When those borrowing needs became concentrated on the sovereign borrowers in those countries[6] in a recessionary context, financial investors started doubting their creditworthiness, thus triggering the Eurozone crisis.

The Eurozone crisis is, then, to a large extent a crisis stemming from the monetary union's *institutional* imbalance. A centralised fiscal policy involving the bigger part of public borrowing done in the Eurozone as well as a policy of permanent and automatic financial transfers from surplus to deficit countries would have prevented financial speculation and diminished the polarisation between North and South European states in the wake of the Great Recession. Macroeconomic imbalances between member states would become much less significant, as is the

5 This has been amply documented and discussed. Some examples are C. Lapavitsas, *et al.* (March 2010) 'Eurozone Crisis: Beggar Thyself and Thy Neighbour', Research on Money and Finance occasional report; lecture by Martin Wolf, *Financial Times* chief economics commentator, at the Foundation for Law, Justice and Society, Oxford, titled 'The Place of Britain in a Future Europe', 5 October 2012, available for viewing at: [https://www.youtube.com/watch?v=FPTK3Nk5cLQ].

6 Before the Great Recession countries like Spain or Ireland (or Cyprus for that matter) were among the best performing Eurozone states in terms of public indebtedness. It was the private sector which was doing the borrowing from abroad, blowing up housing bubbles in the process. That debt found its way onto the public books when the crisis hit, and public debt to GDP ratios soared.

case in the US. The Eurozone would have been much more robust financially and economic recovery would be quicker.

In this article I attempt to analyse the Eurozone's institutional imbalance by looking at the political history of Europe's monetary union. My argument is that this imbalance stems from the ambiguity in France's European policy ever since the early fifties. That ambiguity led France to push for monetary union as a way to curtail Germany's monetary primacy within Europe, while refusing to contemplate steps towards fiscal and political union. I further argue that the way the Eurozone crisis is playing out is pushing France towards accepting such steps, thus laying down the premise for the eventual elimination of the Eurozone's institutional imbalance.

My argument can be traced back to a basic insight by one of the 'founding fathers' of the European Union, who also happened to be the leading figure among the pro-European minority of France's political elites. That figure is Jean Monnet, author of the Schuman plan that in 1950 set in motion the process of European integration. In his memoirs, Monnet argues that 'Europe will be made through crises and will be the sum of the solutions provided to those crises'.[7] In this view, crises act as a kind of catalyst that overcomes political stalemates and leads to a new round of institutional centralisation at the supranational level. The Eurozone crisis should be seen as one such crisis whose result will be institutional innovation at the Eurozone level.

The Strategic Ambivalence of France's European Policy as the Root Cause of the Eurozone's Institutional Imbalance

Monnet and his followers invented the concept of European 'community' institutions as a way of dealing with the American decision to rehabilitate the German economy and to create and arm a federal German state in the late 1940s. Monnet's idea was that binding together France and Germany through supranational institutions would create common interests and render the two countries interdependent, thus preventing a relapse into interstate rivalry in Europe. The end point of the process would be a 'United States of Europe', the model for which was the USA,[8] based on strong federal institutions.

This strategy amounted to a radical departure from France's traditional European policy. Ever since the mid-nineteenth century, French policy sought to prevent the establishment of a unified and centralised German state east of the Rhine. French elites feared, correctly as subsequent developments were to prove, that such a state would come to replace France as the leading power on the continent. After German unification, French policy persisted in its fundamental goal and aimed at the dismemberment of Germany, a goal pursued both during the Versailles peace negotiations in 1919 and at the end of World War Two.

However, Monnet's vision of what France's European policy should be never managed to rally

7 J. Monnet (1976) *Mémoires* [Memoirs], Paris: Fayard, pp. 615–616.
8 Reading through Monnet's memoirs makes this abundantly clear.

decisive support among French political elites.[9] Monnet and his followers only ever had the upper hand in France during the very early years of European integration, from 1950 to 1953. Ever since the failure of the proposed European Defence Community (EDC)[10] in the French parliament in August 1954, and especially since the inception of the Fifth Republic in 1958 and in particular during General de Gaulle's tenure as President of that Republic from 1959 to 1969, France has been on balance suspicious of the EU's federal institutions and very much jealous of her national prerogatives. Although not reverting back to anti-germanism, the general thrust of France's European policy has been to hedge against Germany's potential to re-emerge as the dominant power in Europe by building a European system around a Franco-German interstate axis. The French state has been expected to have the political upper hand in such an arrangement due to France's status as a nuclear power with significant diplomatic clout. The success of this policy has been perceived as hinging on the continued existence of France's centralised state apparatus and the prevention of its dissolution into euro-federal institutions. The French governments' preferred course of action has therefore been to seek intergovernmental cooperation on issues where they plainly cannot go it alone. Only when such intergovernmental cooperation fails to enable France to reach its goals have French governments considered creating or strengthening federal institutions, thus falling back on Monnet's strategic vision.

France's traditional hostility towards the EU's federal institutions has been in particular associated with de Gaulle's political legacy. The Gaullists even campaigned against the Maastricht treaty in 1992 and a good number of them campaigned against the ratification of the European Constitution in 2005. During the 'empty chair' crisis in 1965, when de Gaulle successfully blocked a bid by the first president of the European Commission, Walter Hallstein, to significantly reinforce his institution's powers,[11] the French president laid out his views in a conversation with his associate Alain Peyrefitte:

> 'Hallstein thinks he is the president of a supranational government. He doesn't even hide his game, which consists of wanting to replicate at the European level Germany's federal institutional structure. The Commission would thus become the federal government. The European parliament would become the equivalent of the Bundestag [the German parliament]. The Council of Ministers would become the Bundesrat, that is the Senate! This is madness. But make no mistake about it: this is an institutional drift which would end up being implemented unless we stand in the way. And we are the only ones with the power to do so.'[12]

9 C. Parsons (2003) *A Certain Idea of Europe*, Ithaca: Cornell University Press traces the history of the conflict between pro-Europeans and Euro sceptics in France.

10 See *ibid.*, chapter 2. The EDC was another brainchild of Monnet's. It was his solution to the problems spawned by the American decision to rearm West Germany. A European army and defence minister were to be created, thus integrating German divisions in a single command structure.

11 J. Gillingham (2003) *European Integration 1950–2003. Superstate or New Market Economy?*, Cambridge: Cambridge University Press, pp. 55–66 on Hallstein and his federalist scheme.

12 Quoted in A. Peyrefitte (1997) *C'était De Gaulle: Tome 2 La France Reprend sa Place dans le Monde* [This was

France's suspicion of federal institutions applied to the field of macroeconomic policies. This is the important thing to keep in mind when attempting to understand the history of Europe's monetary union and how it came into being as an incomplete set of institutions.

The Origins of the Euro: The Werner Report, the End of the Bretton Woods International Monetary System and the Assertion of German Monetary Primacy during the 1970s

The origins of the process of European monetary unification provide a clear illustration of the fact that the Eurozone's institutional imbalance does not stem from a lack of foresight on the part of the monetary union's architects. The Werner report of 1970[13] envisaged a process whereby the passage to economic and monetary union would entail two key institutional innovations. The first would be a supranational 'centre of decision for economic policy' accountable to the European parliament, that is an institution akin to a federal finance ministry. The second would be a European system of central banks. Moreover, the report clearly took into account the role of fiscal transfers in solidifying the potential monetary and economic union.[14] Finally, the report explicitly stated that 'economic and monetary union thus appears as a leaven for the development of political union, which in the long run it cannot do without'.[15]

The Werner report, however, and in particular the proposal of a 'centre of decision for economic policy', triggered a sharp and hostile reaction on the part of the French government in the name of national sovereignty.[16] The German government, by contrast, was rather enthusiastic about it.[17] The resulting compromise blocked further progress in a federalist direction. The governments of the Six member states agreed on a few insignificant measures of monetary cooperation[18] with the aim of securing a greater measure of exchange rate stability between the currencies of the member states of the common market.

De Gaulle: Volume 2 France's Place in the World Restored], Paris: Editions Fallois/Fayard, p. 286.

13 Council-Commission of the European Communities (1970) *Report to the Council and the Commission on the Realisation by Stages of ECONOMIC AND MONETARY UNION in the Community 'Werner Report'*, Supplement to Bulletin II – 1970 of the European Communities.

14 See the discussion of the Werner Plan in H. James (2012) *Making the European Monetary Union*, Cambridge MA: The Belknap Press of Harvard University Press, pp. 74–85. James discusses the role of fiscal transfers in pp. 77 and 78.

15 *Werner Report*, p. 12.

16 R. Frank (1995) 'Pompidou, le Franc et l'Europe, 1969–1974' [Pompidou, the Franc and Europe, 1969–1974], in Association Georges Pompidou *Georges Pompidou et l'Europe* [Georges Pompidou and Europe], Bruxelles: Editions Complexe.

17 James, *Making the European Monetary Union*, *op. cit.*, pp. 81–82.

18 A European Monetary Cooperation Fund was created with the aim of organising, within a multilateral framework, cooperation among central banks. More specifically, the Fund's role was to create credit lines (swap

But, the end of the international monetary system that had been established in 1944 at the Bretton Woods conference in the United States wreaked havoc in the monetary balance of forces in Europe as soon as this compromise was arrived at. Since the early fifties, the Federal Republic of Germany (FRG) had amassed accumulating trade surpluses and the Deutsche Mark (the FRG's currency) had continued to appreciate in relation to the dollar but also in relation to the other European currencies. France was in the exact opposition situation, with regular trade deficits and a national currency (the French franc) that had become a weak currency and that was dependent on regular devaluations.[19] The Netherlands displayed similar performances to Germany, whereas Italy was closer to France. In other words, the current pattern of macroeconomic imbalances within the Eurozone stretches back to the early fifties. In fact, it could even be said to stretch back to the late nineteenth century and the emergence of Germany as the industrial powerhouse of continental Europe. In any case, the point here is that the split between surplus and deficit countries mentioned in the introduction is not new and closely matches the pre-euro era split between strong and weak currency countries.

In that context, the sharp depreciation of the dollar's value that followed President Nixon's August 1971 decision to renege on the United States' commitment to convert dollars into gold triggered a huge influx of capital into Germany. This phenomenon of monetary speculation (that came to be known as the 'dollar/Deutsche Mark polarisation effect') inflicted chaos in the monetary relations of the countries of the common market and called into question both the Common Agricultural Policy (CAP) and the further pursuit of commercial integration. The Europeans were faced with only two choices. One option was to somehow manage to convince the US government to cooperate by implementing an austerity programme in order to reduce its current account deficit and thus stabilise the dollar. A second choice was to come up with a European response to counter the aggressive exploitation by the Americans of the 'exorbitant privilege'[20] that the dollar's status as the major and unchallenged international reserve currency procured them (and still does). As the first solution was out of reach given the balance of forces between Europe and the US at that point in time, the only viable solution for the Europeans was

agreements) between central banks for the lending of official reserves with the purpose of carrying out operations in the currency markets in order to defend the parities between European currencies.

19 In the autumn of 1949, the dollar/Deutsche Mark exchange rate was set at 1:4.2. In 1998, when the euro was introduced, the dollar was only worth 1.67 Deutsche Marks. On the contrary, the French franc started from a rate of 1:3.5 and ended up at a rate of 1:5.63 against the dollar. At the same time, the French franc/Deutsche Mark rate passed from 083:1 to 3.3:1. cf. J. Bibow. (2013) 'On the Franco-German Euro Contradiction and Ultimate Euro Battleground', Levy Economics Institute of Bard College working paper no. 762.

20 The term 'exorbitant privilege' was coined by de Gaulle's adviser for economic policy Jacques Rueff, and was used by the French government extensively during the 1960s to attack the dollar's status as the main international reserve currency. B. Eichengreen (2008) *Globalizing Capital: A History of the International Monetary System*, Princeton: Princeton University Press, p. 114.

to progressively organise the concerted floating of European currencies against the dollar (initially this took the shape of the 'snake' system, then starting in 1979 the European Monetary System (EMS) was introduced).

However, this solution established German monetary primacy within Europe. The concerted floating of European currencies against the dollar in essence created a monetary area whose anchor was the Deutsche Mark. For weak currency countries wanting to remain in the system, this entailed regular adjustment of their economies through austerity measures in order to reduce their trade deficits and strengthen their currencies on the currency markets. Their only alternative was to use their accumulated official reserves to defend their currencies. The crux of the matter is that their official reserves were by definition limited whereas the Bundesbank (the German central bank and as such, the most important strong currency country central bank in the system) could print as many Deutsche Mark as it chose in order to intervene in the currency markets in defence of the weak currencies. What is more, this allowed the Bundesbank to accumulate official reserves and thus tended to further reinforce its power. In this context, the German central bank was in a position to determine both the monetary policies of the countries in the system and the margins within which they could conduct their broader macroeconomic policies. Because the Bundesbank was wary of printing more Deutsche Mark than warranted by domestic monetary policy considerations, its default policy preference was to intervene in support of weak currencies as little as possible. In consequence, weak currency countries only really had the option of tightening fiscal and monetary policy if they wanted to stay in the system.

The French Quest for a 'Symmetrical' EMS

French governments reacted as this new reality of monetary power within Europe became established by attempting to impose on Germany a more cooperative attitude in the field of economic and monetary policy. Their aim was to arrive at a compromise that distributed the burden of adjustment in a more balanced way between strong and weak currency countries. This strategy would, in time, push French governing elites to accept what Pompidou had considered to be unacceptable at the time of the Werner report, that is the creation of supranational (or federal if one prefers the term) institutions and rules. At the same time, the German government made a move in France's direction. This was especially so after 1977–1978 when the sharp depreciation of the dollar pushed the Deutsche Mark through the roof, prompting German industrialists with a strong export orientation to demand that measures be taken to ward off the appreciation of the Deutsche Mark.[21] German politicians, high-ranking civil servants and even the Bundesbank's directors were sensitive to these demands all the more so that they were afraid that a permanent

21 Parsons, *A Certain Idea of Europe*, *op. cit.*, p. 167.

appreciation of the German currency might lead to the offshoring of production units and thus to spiking unemployment in Germany.[22]

The agreement to create the EMS illustrates the evolution in French attitudes. France accepted the idea of mutualising part of its official reserves in a potential European Monetary Fund (EMF) and proposed a system based on a new unit of account, the European Currency Unit (ECU). The ECU would be a basket of European currencies and each one of them would have a fixed parity with the ECU. Given that in the past, the currency that tended to diverge was the Deutsche Mark, this new system would rebalance the burden of adjustment by forcing the Bundesbank to intervene much more often than in the past. In other words, the French accepted to limit their own policy autonomy by mutualising part of their official reserves in exchange for taming the Bundesbank.

That, however, was not an agreement the Bundesbank was ready to accept so easily. The German central bank forced the government to reject the system proposed by France (towards which chancellor Helmut Schmidt was favourably inclined) in favour of a system of bilateral parities which strongly resembled the 'snake' and later on expunged the proposed EMF. It even managed to sway the government, through the notorious Emminger letter of November 1978, to agree that it could unilaterally renege on the commitments imposed on it by the EMS in case it would judge the interventions in favour of weak currencies imposed on it by the agreement to be inflationary.[23] In other words, the EMS was still a Deutsche Mark area where the burden of adjustment fell almost entirely on weak currency countries and in which the Bundesbank was the most powerful central bank.[24]

French governments, both of the left and the right, persisted during the decade that followed the setting up of the EMS, namely the eighties, in trying to reform the EMS in a way that rendered it more 'symmetrical'. At the same time, they reluctantly decided to pursue a policy of austerity, alternatively referred to in France as the policy of the 'strong franc' or 'competitive disinflation'. The policy entailed raising interest rates and cutting public spending, in the process inflicting real pain and generating significant industrial restructuring that dramatically improved the competitiveness of French firms, a policy course which during most of the seventies was anathema to French governments. When, for example, in 1976 president Giscard attempted to steer such a course, his Gaullist prime minister and future president of the Republic, Jacques Chirac, resigned his post in fury at having to conform, in his perception of things, to the diktats of foreigners. Both terms indicate that the main objective of French governments was not to tame inflation for its own sake

22 D. Marsh (2011) *The Euro: The Battle for the New Global Currency*, New Haven: Yale University Press, p. 85.

23 James, *Making the European Monetary Union, op. cit.*, p. 174.

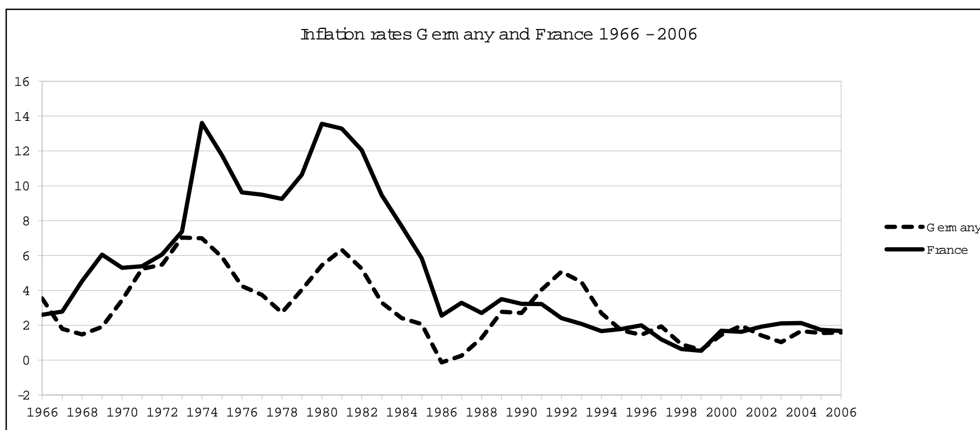
24 Hence the title of David Marsh's famous 1993 book – at the time Europe correspondent for the Financial Times – *The Bank that Rules Europe*, London: Mandarin.

but to eliminate the inflation differential between France and Germany. This did not stop them from hoping to convince the German government to agree to a concerted reflation.[25]

From the 'Symmetrical' EMS to the Euro

The first half of the eighties had seen a respite in the Deutsche Mark/dollar polarisation effect as the 1979 interest rate hike by the Federal Reserve in the US sucked capital into the dollar and led to its appreciation. But the 1985 Plaza accords turned the tide and the dollar plunged once more, setting the polarisation effect in motion again. The EMS was the object of international financial speculation yet again and this was so despite the fact that the inflation differential between France and Germany had almost disappeared (see figure 1). Moreover, the 1986 Single European Act (whereby the Europeans decided to complete the Common Market thus re-launching the process of economic and political integration) included, at Germany's insistence and despite French and Italian scepticism, a provision to liberalise capital movements by 1992. The impact of such a liberalisation would surely be to reinforce speculative pressures stemming from the financial markets. French leaders were worried that the liberalisation of capital movements might further strengthen the power of the Bundesbank and reinforce the Deutsche Mark's position in the EMS by intensifying speculative pressures.

Figure 1: Inflation in France and Germany (Variation over one year in %)



The new French government under Gaullist premier Jacques Chirac (elected in 1986 and staying in office for two years) renewed with greater vigour the French demand that the

25 D. Howarth (2001) *The French Road to European Monetary Union*, London: Palgrave, p. 105. That basically would mean that Germany would agree to increase public spending and/or wages – the similarity between then and now is of course not fortuitous.

Bundesbank behave in a more cooperative fashion, but substantial changes were not forthcoming.[26] Moreover, German trade surpluses reached new heights during the latter part of the eighties (see figure 2). The French government's failure to obtain a more 'symmetrical' EMS despite substantial austerity measures and the prospect of a further deterioration in French monetary power *vis-à-vis* the Bundesbank thus prompted the French finance minister Edouard Balladur – another Gaullist and no federalist enthusiast – to propose in January 1988 the creation of a European central bank.[27] The proposal corresponded perfectly with the preferences of German foreign policy leaders and administrations – the German foreign minister at the time, Hans-Dietrich Genscher was an ardent federalist, and so was the chancellor, Helmut Kohl. Both of them understood that the French proposal opened up the perspective of speeding up the process of political union (which the German government would attempt to accelerate during the Maastricht treaty negotiations, where French and British opposition would keep developments to a minimum).[28]

However, in the negotiations that followed and that led to the Maastricht treaty, the balance of forces meant that the party with the most to gain from an eventual agreement – France – must make major concessions.[29] In other words, the price for eliminating the Bundesbank's primacy in monetary affairs was to agree to the conditions set by Germany. These essentially consisted of applying the Bundesbank model to the future ECB (that is, an independent central bank and the assignment of monetary policy solely to the task of fighting inflation and not of stimulating growth – which, for instance, is part of the mandate of the Federal Reserve). As a side payment to weak currency countries, Germany accepted a Commission proposal to set up a limited system of financial transfers, which became the Structural and Regional Development Funds of the EU budget. These would later on be scaled down to a minimum with the prospect of Eastern enlargement.

To the extent that the negotiation only dealt with issues of monetary policy and did not include discussions on how to move towards a federal Treasury and a fiscal union, the German government imposed two further conditions. The first was the institution of a set of rules aimed at prompting macroeconomic convergence among the member states that wanted to adopt the euro, for it was obvious that persistent inflation differentials within the monetary union would be a source of instability. These were the five Maastricht criteria which in 1997 were turned into the Stability and Growth Pact. The second condition was the *no bail-out* clause stipulating that no

26 Marsh, *The Euro*, *op. cit.*, pp. 117–119.

27 C. Balleix-Banerjee (1999) *La France et la Banque Centrale Européenne* [France and the European Central Bank], Paris: Presses Universitaires de France, p. 21.

28 A. Moravcsik (1998) *The Choice for Europe: Social Purpose and State Power from Messina to Maastricht*, Ithaca: Cornell University Press, pp. 317–471.

29 Moravcsik, *Choice for Europe*, *ibid.*, pp. 430–447.

member state could be held liable for the public debts of other states participating in the monetary union. The function of this clause was dual. On the one hand, the German government intended to signal to financial investors that member states' public debts were not interchangeable and that premiums between say German debt and Greek debt should not disappear. Persistent premiums were expected to ensure that the pressure to pursue orthodox fiscal policies would be maintained on weak currency countries. On the other hand, the clause was intended as a safeguard against a 'fiscal union by stealth' situation, where the German government would be made liable for the public debts accumulated by weak currency member countries because of no other viable policy option, without, however, being in a position to control their economic and fiscal policies.

Nonetheless, the federalist logic that was entailed in the Maastricht agreement could not be permanently pushed under the carpet. The decade and a half that followed was thus marked by a quasi-permanent institutional debate. Three treaty revisions, agreed upon in Amsterdam, Nice and Lisbon have been implemented. But even more important for understanding the Eurozone's institutional imbalance are the proposals that were not implemented. As early as 1994, Germany rekindled the institutional debate through the so-called Lamers/Schäuble paper.[30] This document essentially proposed a method for moving towards a federal structure around a hard core of countries made up of the member states that would eventually adopt the euro. The proposal was more or less reiterated in the same terms by the German foreign minister Joschka Fischer in 2000, in a speech delivered at Humboldt University in Berlin.[31] But each time, the French reaction was to elude the debate due to France's ambiguity towards the development of federal institutions.[32] French governments rather chose to champion as of Maastricht the concept of an 'economic government' for the Eurozone, made up of the representatives of Eurozone governments. Their aim was to constrain the independence of the ECB, thus hoping that the Bank would be forced to pursue looser monetary policies.[33]

After the Maastricht treaty was signed, scepticism about the proposed monetary union was very strong among economists, especially in the US.[34] British euro sceptics fulminated against the

30 CDU heavyweights Karl Lamers and Wolfgang Schäuble were its authors. CDU/CSU (1994) 'Überlegungen zur Europäischen Politik' [Reflections on European Policy], available at: [http://www.cducsu.de/upload/schaeublelamers94.PDF], accessed 12 March 2014.

31 'L'Europe Unie Selon Joschka Fischer' [United Europe according to Joschka Fischer], *Le Monde*, 15 June 2000, p. 12.

32 Alain Juppé, French foreign minister at the time of the Lamers/Schäuble paper's publication, stated in reaction to it that 'federalism is not France's philosophy' (A. Leparmentier (2013) *Ces Français Fossoyeurs de l'Euro* [The French Grave Diggers of the Euro], Paris: Plon, p. 46, and pp. 41–48 more broadly on the French reaction to the paper). On the debate that followed Joschka Fischer's speech at Humboldt, see issue 3 of the journal Dokumente/Documents, published in 2000.

33 D. Howarth (2007) 'Making and Breaking the Rules: French Policy on EU "Gouvernement Economique"', *Journal of European Public Policy*, Vol. 14, No. 7, pp. 1061–1078.

34 L. Jonung and E. Drea (2009) 'The Euro: It Can't Happen. It's a Bad Idea. It Won't Last. US Economists on the EMU, 1989–2002', European Economy economic papers 395.

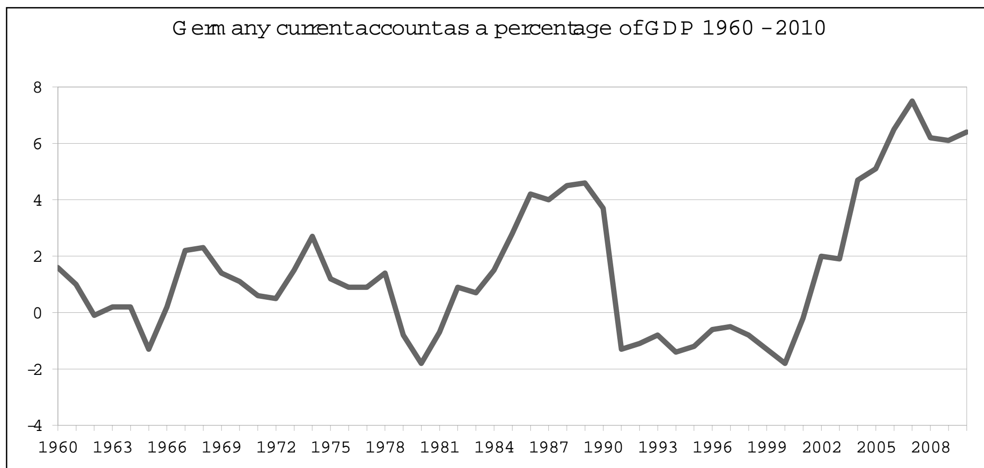
euro and predicted that its institutional imbalance would give at some point the opportunity for 'eurocrats' to argue that a fiscal union was necessary to complement monetary union.[35]

When the first Greek bail-out was agreed upon in May 2010, after months of pressure exerted on the German government to step in, including public criticism of Germany's trade surplus by then French finance minister Christine Lagarde,[36] Wolfgang Schäuble, now finance minister, retorted by pointing out France's contradictions. In an interview with the *Financial Times* he said that 'When we introduced the euro in the 1990s, Germany wanted a political union and France did not. That is why we have an economic union without a political union ... If you want to create a federal organisation, you must be ready to have a certain amount of redistribution within it. You can dismiss that by rudely calling it a "transfer union". But strong and weaker states both have their responsibility.'[37]

The Current Crisis Lays Bare the Institutional Imbalance and Poses Anew the Question of Political Union and Federalism

The burden of German reunification during the nineties meant that the process leading up to the introduction of the euro took place under exceptional historical circumstances, since the German current account was in deficit throughout the entire decade (see figure 2).

Figure 2: Germany Current Account (Current account EUR Million)



35 See in particular, B. Connolly (1995) *The Rotten Heart of Europe*, London: Faber and Faber. Connolly, apart from a staunch Thatcherite, had also been one such 'eurocrat' and was responsible for monetary policy at the European Commission, until the publication of his book led to his sacking. A milder version of his arguments was also echoed by Martin Wolf at the *Financial Times*.

36 B. Hall (2010) 'Lagarde Criticises Berlin Policy', *Financial Times*, 14 March 2010.

37 Q. Peel (2010) 'Schäuble Interview: Berlin's Strictures', *Financial Times*, 19 May 2010.

This reversal of fortunes dampened the functional logic that entails the creation of a fiscal union to accompany monetary union. Moreover, it lent credibility to the analysis according to which current account imbalances do not really matter in a monetary union.[38]

In addition, financial investors did not really understand the message that the *no bail-out* clause was meant to convey. Sovereign spreads between Eurozone member states disappeared. Furthermore, the fall in nominal interest rates in weak currency countries entailed by the passage to a single monetary policy reduced real interest rates in those countries. All the ingredients for the development of credit bubbles were in place. Worse than that, as of 2000 the German current account returned to a structural surplus position. Only this time German surpluses were far bigger than anything that went before since the integration of European financial markets had created a single financial market that is much deeper and that allows for the financing of ever bigger current account deficits.[39] When these credit bubbles burst before[40] and after the Great Recession of 2008–2009, it slowly became obvious that a classic balance of payments crisis was in the making, only instead of provoking exchange rate crises (as in Asia in 1997 for example) in this case it triggered a sovereign solvency crisis. The problem was no longer one between weak and strong currencies that could be solved through interest rate hikes by weak currency country central banks. It became a fiscal problem and the immediate issue at hand was to prevent sovereign defaults. Doing so meant that Germany had to give up on the idea of preventing a drift to fiscal union. After some hesitation in late 2009 and early 2010, and as the Greek crisis threatened to categorically get out of hand, the German government resolved to play the game. Conversely, that meant that it would be setting the rules once again.

The response that was gradually assembled in 2010–2012 involves rudimentary institutional innovation (the European Financial Stability Facility (EFSF) – then the permanent European Stability Mechanism (ESM)) that is akin to the beginnings of a fiscal union. In effect, these institutions are mechanisms for organising limited fiscal transfers from surplus to deficit countries in the form of loans between governments and the limited pooling of liability.[41] A version of Eurobonds has even been introduced, in the form of the bonds issued by the ESM. The recently agreed upon banking union, quite apart from its huge significance in terms of public control over

38 Marsh, *The Euro*, *op. cit.*, pp. 240–241.

39 James, in *Making the European Monetary Union*, points out that the imbalances between European countries tend to grow bigger (as a percentage of GDP) during the entire period stretching from the early sixties to today due to the increasing integration of financial markets.

40 The Irish housing bubble burst in 2006.

41 The loans can be said to constitute fiscal transfers to the extent that they are provided at a rate that is much lower than market rates. In the case of Greece, the repeated 'reschedulings' of the loans (whereby maturities have been extended and interest rates cut) constitute additional transfers. The pooling of liability is not formal but none the less real. The EFSF or ESM lend to embattled states so that they can pay off their debts. If those states then default on their debt towards the European lending institutions, then the latter will be footing the bill for those states' previous debts.

national banking systems, also entails an element of fiscal union. The Single Resolution Fund, that will be used in the case that European authorities decide that a bank has to be wound down or recovered, will be funded by contributions levied on Eurozone banks. These contributions are nothing other than the proceeds of a special European tax.

In exchange for this, the surplus countries have obtained the right to control the economic policies of assisted countries through the conditionality attached to the loans and the role played by 'Troika' officials. Those conditions, in turn, are broadly in line with the German government's preferences. They very much resemble the structural adjustment programmes championed by the International Monetary Fund (IMF) in the 1980s and 1990s in developing countries requiring assistance. A more permanent mechanism for exercising such control comes in the shape of the new powers granted to the European Commission to review member-States' annual budgets and to hand out fines to those deviating from the updated criteria contained in the Fiscal Compact agreed upon in December 2012.[42] The Compact also includes provisions for the introduction of so-called 'Golden Rules', that is to say laws mandating nearly balanced budgets. All told, the new rules strengthen the pressure on deficit countries to implement structural adjustment policies.

The parallel between the current situation and the EMS is striking. For the system to hold together, an adjustment must take place so that macroeconomic imbalances are reduced. Germany can contribute to this by cooperative policies – monetary in the past, fiscal today (in the shape of public spending increases and fiscal transfers). The political alternative that deficit countries face is between a system of fiscal transfers that is organised on an *ad-hoc* and intergovernmental basis (as is the case with the European Stability Mechanism) where Germany has *de facto* veto powers over the operation of the system (just like the Bundesbank did in the EMS); and the gradual setting up of a federal system, where fiscal transfers would be automatic and administered through a supranational Treasury, collectively controlled by the member states of the new fiscal union and within which surplus countries could potentially even find themselves in the minority (as has been the case within the ECB governing council where the German representatives and the Bundesbank have strongly disagreed with the policies pursued since the start of the Eurozone crisis in May 2010).[43] In such a situation the amount of fiscal transfers from surplus to deficit countries might also increase.

42 The Compact is formally the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union.

43 Both former Bundesbank president Axel Weber and former member of the ECB's board of directors Jürgen Stark resigned their posts in 2011 due to their disagreement with the ECB's policies towards deficit countries. Since then, the Bundesbank has continued to publicly express its opposition to the ECB's policies. Its two targets are on the one hand the ECB's policy for providing liquidity to banks and on the other the OMT programme announced in September 2012 (soon after Draghi's 'whatever it takes' statement). The ECB has, since the beginning of the crisis, lowered significantly the rating criteria for the collateral it accepts from commercial banks for refinancing operations. Then, in early 2012, it launched the LTRO programme of providing very cheap credit on long-term

This presents France with another tough choice. Essentially, it means that the debate about fiscal and political union that was eluded in the nineties has certainly to take place now and result in new institutions at the Eurozone level. That process has already started. On the one hand, some of the staunchest supporters of national sovereignty seem to be reconsidering their positions. One such 'sovereignist' is former Prime Minister François Fillon. Fillon was a close collaborator of Philippe Séguin in the nineties, the leading Gaullist detractor of the Maastricht treaty on national sovereignty grounds. Fillon is now in favour of political union and a European finance minister.[44] On the other, the French bureaucracy has started drafting proposals for a first move towards a federal fiscal union through a small Eurozone budget.[45] Finance Minister Pierre Moscovici has also raised the idea of a Eurozone unemployment insurance scheme. Additionally, he has advocated the swift setting up of the banking union and the extension of the Single Resolution Fund's mandate to include the capacity to borrow on the markets.

It is difficult to predict in detail how things will play out but for the moment, the innovations envisaged (contracts between member states and the Commission on economic policy and a small Eurozone budget with some involvement from Eurozone MEPs) are quite limited, although they are pointing in the direction of a federal fiscal union. This is probably associated with the fact that the EU is not as popular in the broader public opinion as it used to be in a number of key places, not least France. The memory of the 2005 referendum is at the back of every mainstream French politician's mind. This partly explains why the German chancellor has cooled on the idea of pushing for Treaty revision and political union,[46] whereas in 2011 and 2012 she openly campaigned for that.[47] What is certain, though, is that the Eurozone crisis has once again set in motion the process of European integration.

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maturities to banks. These moves were intended to prop up banks in South Europe. Finally, both Chancellor Angela Merkel and the Bundesbank have recently stated their preference for higher interest rates. Despite that, the ECB moved in the autumn of 2013 to further lower interest rates, in a move opposed by most North European members of its governing council.

44 F. Lemaître (2013) 'François Fillon, Désormais Européen Convaincu' [François Fillon, Henceforth a Convinced European], *Le Monde*, 26 April 2013. When the journalist pointed out to him the apparent contradiction between his earlier position and the current one, Fillon's reaction was to say that he was 'against the single currency because I thought it entailed a single economic policy. Since we can't do away with the euro, we need to further deepen European integration'.

45 P. Ricard (2013) 'Quand Moscovici Tente de Faire Vivre l'Idée d'un Budget de la Zone Euro' [Moscovici Attempts to Rally Support in Favour of a Eurozone Budget], *Le Monde*, 24 October 2013.

46 M. Amann, P. Müller, R. Pfister and C. Schult (2013) 'Chancellor Merkel Cools on European Integration', *Spiegel Online*, 25 June 2013.

47 Q. Peel (2011) 'Merkel Urges Stronger Union to Back Euro', *Financial Times*, 14 November 2011.

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