

Monetary Union and the Single Currency

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This short note first examines the best way of conceptualizing the story of European integration, but also reflects on the extent to which the peculiarities of that history may have been responsible for some design flaws in the project.

The monetary union that was accomplished in the 1990s in Europe is quite unprecedented in the story of inter-state relations. It was long accepted that money was a creation of the state: even in the world of the gold standard, the state set the ratio of precious metal to a unit of currency through legislation. The new money was not only not a creation of a state; it was managed by a new institution, the European Central Bank, whose constitutional position within the European Union is (until the Lisbon Treaty comes into force) quite unspecified.

There are four major traditions of thinking about the history of monetary union:

1. In the logic of functionalism, increasing interaction creates a logic of yet more interaction.
2. In a constructivist approach, the monetary union represents the victory of a new set of ideas (Kathleen McNamara's "currency of ideas").
3. Analysts who focus on inter-state relations show how the monetary union was an outcome of a bargaining process between states (Moravcsik), in which a German view of central bank independence triumphed over a French philosophy of economic governance, and laid the basis for increased German ascendancy in the economics and politics of the EU (Marsh).
4. Finally, the negotiations might reflect the outcome of "multi-level games" in which institutions develop an autonomy in which they seek their preservation and strengthening through cross-national partnerships – in practice this argument is a sophisticated explanation of the logic that drives (1).

How far can these theories be tested against a historical account of the evolution of monetary union?

1. The first story appears *prima facie* implausible, as there are plenty of periods of stagnation and reversal, when there seems to me more disintegration than integration. The story of monetary union is not a one way street.

2. The constructivist account faces the difficulty that there were plenty of ambitious plans for monetary unification (including the Werner Plan and the Fourcade Plan: see Mourlon-

Druol) or monetary coordination and management (the Snake, FECOM) that were never or only imperfectly and partially realized; and conversely it is clear that a substantial number of the participants in the Delors Committee, which in retrospect seems to have laid down the fundamentally decisive mechanism for integration, at the time believed that their activities were fundamentally futile. In this sense, the policy community of central bankers, strong as it was, was incapable of exercising influence by itself.

3. An inter-governmental approach raises the painful question (that has been constantly raised in French domestic politics) of whether France did not get a very bad bargain, and if so, what led France to accept the German view of central bank independence at the time of the Delors report, and then to see the Delors report as the only acceptable or realistic road to monetary union.

4. The final approach is enticing, but has so many actors and variables that it cannot really be presented as creating a roadmap of the integration process. It sees the central banks as the major actors, in that the Bundesbank initially resisted Hans-Dieter Genscher's European plans and then used Europeanization to preserve its autonomy from the German government; while much more clearly Jacques de Larosière, Governor of the Banque de France at the time of the Delors report, saw the mechanism as a way of providing for greater stability and reliability of French domestic policy. A few years later, however, the Bank of England obtained the same independence and autonomy (from the new Labour government in 1997) without needing the additional support of Europeanization. Why did European central banks really need Europe to obtain operational independence?

In regard to this sort of argumentation, a comparison of the integration discussions of the 1970s and 1980s is instructive. The negotiations to create the EMS and its associated ERM were largely governmental: though Roy Jenkins saw this as his initiative as Commission President, the actual success depended on the high-level cooperation of Helmut Schmidt and Valéry Giscard d'Estaing. This is the conventional picture and there is no reason to think it wrong. By contrast, when Jenkins's successor Jacques Delors wanted to initiate a monetary discussion, he very deliberately started the process through an intense cultivation of the central bankers, largely through their regular meetings at the Committee of Central Bank Governors in Basel.

One way of going more deeply into this debate is to examine which issues mattered most to the central bankers who were at the heart of the negotiations of the late 1980s and early 1990s. They were concerned with three sets of issues

- The establishment of a common framework for setting monetary policy, which required a great deal of technical coordination and had been the subject of intense work by experts' groups since the 1970s. In its very first meeting, the Committee talked about unifying and standardizing monetary terminology. In 1973 the Committee – cooperating with the EC Monetary Committee – established an experts' group (the Bastiaanse group) that aimed at harmonizing the intermediary objectives of monetary policy.

- Concern about the monetization of fiscal deficits, which found its way into the provisions of the Maastricht Treaty.
- Concern about a common framework for banking supervision and regulation, which was a major concern of work at the BIS. Such issues were regularly put forward as prominent features of the design of a new integrated capital and money market in the late 1980s. But these concerns did not find their way into the Maastricht Treaty.

This third problem was often picked up by academic critics who worried about the design of the European monetary order. The problems of European banking in the aftermath of the sub-prime crisis indicate that this was the major institutional flaw of Europe's monetary arrangements.

In the past, financial sector shocks have played a decisive role in the undermining of monetary regimes and the discrediting of the central banks responsible for their operation. The most dramatic of such episodes occurred in the interwar Great Depression, where banking panics in central Europe and the United States exacerbated the problems of the real economy. Unstable banks withdrew credits from borrowers, forcing firms that would otherwise have been solvent to liquidate stock at depressed prices. The major industrial countries that had significant banking problems fared significantly worse than those economies with no or only limited banking collapses. In particular the United States, with waves of banking panics after the fall of 1930, and Germany, with a meltdown of the banking system in June and July 1931, were very badly hit by the real consequences of the financial storm; these experiences have very obvious current echoes (that were not at all obvious even a few years ago).

The weakness of the American and German banks in the interwar era was at least in some measure the consequence of political federalism. Federalism

1. encouraged the development of a banking system that was regional in character. In particular in the United States, state banks suffered because their risk was concentrated in particular sectors.

2. made for inefficiencies in regulating banks. In Germany, a major source of difficulty was the parallel system of Savings Banks (Sparkassen) which were controlled by local authorities, and which responded to local political pressures to lend.

3. produced a dispute about the appropriate monetary response of the central banking institutions. This may be an especially acute problem in the early life of the federation or the central bank. With regard to the United States, Eichengreen (1992) and Wheelock (2000) showed how the Federal Reserve found it difficult to resolve regional conflicts in the early 1920s. Friedman and Schwartz famously presented the major cause of the immobilization of the Federal Reserve System after 1930 as lying in tensions between the New York and Chicago Banks.

Europe is an integrated capital market with national bank regulators that respond in different ways to incipient problems. Since the 1980s, and especially since the introduction of the single currency, the Euro-zone capital market has become partially integrated, but there are

still in some countries substantial and largely unwritten to cross-national financial ownership. Nevertheless, financial institutions operate in this single capital market across national boundaries. Big mergers, such as those between Santander and Abbey National in 2004 and UniCredit and Hypovereinsbank (which had previously acquired a dominant share in the Austrian banking industry) in 2005, started to create Europe-wide superbanks.

The problem of a bank getting into difficulties because of engagements in a different country is a widely recognized problem, in theoretical discussions. But a unification of banking regulation is still a long way from being realized.

At the same time as finance has become internationalized, each country preserves its own idiosyncratic system of financial supervision and regulation. Though there has been an extensive discussion of the possibility of shifting supervision to the European level (Prati and Schinasi 1999; Vives 2001), there are practical obstacles to making such a shift (apart from inbuilt bureaucratic resistance from existing regulators). In particular, regulation is often linked to implicit or explicit lender of last resort functions. But such activity has a significant fiscal cost, which at present cannot be assumed at a European level but would remain an issue for national governments and national parliaments. This is the coordination problem that is currently paralyzing the discussion of European bank rescues and of financial sector reform. When problems involve several countries, they are simply handled bilaterally: by Belgium and the Netherlands in the case of Fortis, by Italy and Austria in the case of UniCredit.

Much of the previous literature has concentrated in consequence on the issue of how bailouts and rescues should be paid for after a financial crisis, as a consequence of the reluctance of national authorities (and their tax payers) to bear the financial burden of bailing out depositors or creditors in other states (Goodhart and Schoenmaker 2006). The current institutional framework unambiguously limits socially beneficial post-crisis workouts. But it may also limit the capacity to provide efficient preventative or pre-crisis prudential supervision. The consequent limits on the extent to which national regulators were aware of bank problems became highlighted in the credit crunch of the summer of 2007. The ECB supplied general liquidity to the market, and may have been able to avoid some financial distress. But it does not have a responsibility to regulate and thus may not be aware of banking problems until a late stage.

Additionally, in the event of financial sector difficulty, the monetary policy response would be highly contested. Conventionally, bailout or reorganization is seen as the answer to solvency problems, while liquidity provision is an answer for solvent but temporarily illiquid institutions. In crisis situations, and where information about credit risk is faulty or incomplete, as in the summer of 2007, such a judgment between solvency and liquidity problems is impossible to undertake. In the absence of an ability to deal specifically with the threat posed by individual institutions and to make choices about crisis support or closing the institution, there will be more pressure on the ECB to simply deal with the situation by extending large amounts of liquidity rather than to address the solvency issues which may be concealed.

The difficulty of an effective Europe-wide response to financial sector problems thus reflects a more general problem with respect to the making of monetary policy: there may be a

different political economy of money in regions of the Euro-zone and EU member countries, leading to contradictory pressures on policy.

Finally, it may be appropriate to suggest that the monetary union and its membership has created a new division in Europe that was originally intended to be flexible, with EU member countries meeting the Maastricht criteria and then joining the monetary union, but as a consequence of the post-2007 financial crisis runs the danger of creating a permanent division, in that countries that have just managed to join the Eurozone (such as Slovakia) are protected from currency mismatch effects, while those outside are likely to be knocked back so severely that their candidacy becomes an impossibility for a substantial period of time.