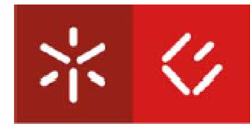

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"The long road to EMU: The Economic and Political Reasoning behind Maastricht"

Francisco Torres

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The long road to EMU: The Economic and Political Reasoning behind Maastricht[1]

by

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Abstract

This paper aims to examine whether the economic and political reasoning behind Maastricht is consistent with earlier approaches to monetary integration. In doing so, it revisits the intellectual debate on monetary integration in Europe at different stages. It concludes that Economic and Monetary Union (EMU) as agreed at Maastricht reflected a compromise between two different but converging preferences, in the context of the experience of the European Monetary System (EMS) and other developments in national and European politics as well as in economic thought, on the role of monetary policy and institutions; the fall of the Berlin Wall may have added a new political dimension that might have made it easier to agree on the blueprint and on the calendar for the realisation of EMU. The various (political and economic) motivations for the convergence of initially different views on the role of monetary policy and successive interpretations of the objectives of EMU are discussed within the wider context of the process of European integration.

JEL classification: N14; E52, E58, E61, E65.

Keywords**:** Economic and Monetary Union; Bretton Woods; European integration; Werner plan; European Monetary System; inflation; convergence of preferences; epistemic communities; currency crisis; monetary sovereignty; Maastricht treaty; convergence requirements.

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1. Introduction

Until the end of the 1960s, the Bretton Woods system served the objectives of monetary coordination in Europe well (laid down in Articles 103 to 108 of the Treaty of Rome). The Monetary Committee was the only Community institution in the field of monetary coordination. The nature of monetary coordination was eminently "Atlantic",[2] as was the case until the fall of the Berlin Wall in 1989 for common external and defence policies. It was difficult to conceive of any concrete actions in that field which did not have the dollar as a reference.[3]

The 1967 sterling devaluation however provided French President De Gaulle with an argument for denying entry into the European Community to the United Kingdom and the devaluation of the French franc greatly affected intra-European trade and the functioning of the Common Agricultural Policy (CAP). As a result of the erosion of the dollar-gold standard, the Hague Summit of 1969 began discussing possible forms of European monetary cooperation and plans for a future monetary union.[4]

Following the Hague Summit, the European Community Economic and Finance Ministers discussed a series of national plans for Economic and Monetary Union (EMU) put forward by Germany[5], Belgium and Luxembourg. The European Commission also presented its own plan. There was a division between those who wanted a prior harmonisation of some economic policies (Germany, with the support of the Netherlands) and those who wanted to move on immediately to the creation of different monetary arrangements (Belgium, Luxembourg and the European Commission with the support of France, which did not present a plan). In March 1970, the Werner Committee was created. It presented its final report in October of the same year with a detailed calendar for achieving Economic and Monetary Union in three stages. The objective of EMU was subsequently approved by the Council but no agreement was reached on the need for common policy

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[2] On the influence of "Atlantic standards" from 1880 until 1973, see Macedo (1996). According to Maes (2006), the Commission was the exception taking "the internal logic of the integration process" and not the international monetary system, as its framework of analysis.

[3] Giavazzi and Giovannini (1989).

[4] Prior to this there had been several initiatives by the European Parliament, such as the Van Campen Report published in April 1962, and by the European Commission, such as its October 1962 Action Plan, and the February 1969 Barre memorandum, which translated among other things into the creation of the Committee of Governors of the Central Banks of the European Economic Community (EEC).

[5] Until 1990, "Germany" refers to West Germany only.

making and on the nature of common supranational institutions,[6] and therefore no Intergovernmental Conference (IGC) was convened to follow up on the idea.

The idea of a common currency or rather simply the permanent fixing of intra-European exchange rates had grown out of the need to maintain an environment of stable competition. An Economic and Monetary Union (EMU) also offered a means for isolating all the European economies from exchange rate volatility and serious misalignments. Such events could affect the macroeconomic stability of weak currency countries and the competitiveness of strong-currency countries, leading to protectionist pressures and/or trade barriers. Moreover, they could also jeopardise the functioning of the customs union (achieved before schedule by 1968) and the already delayed implementation of a common market[7] and indeed of the entire European integration process. In fact, the more European common policies there were, the stronger was the need for fixed exchange rates in the EC. The CAP, based on the establishment of common prices for all Member States, could not work with permanent changes in intra-European exchange rates without very complex interventions to maintain the original established prices. A European monetary union was by then already seen as the logical corollary of a European common market and any common policies.

Since there was no agreement on the institutional design and objectives of an economic and monetary union in the EC, the idea had to wait for almost two decades before being implemented. Other circumstances, such as the end of the Bretton Woods system and the first oil crisis, of course exacerbated that conflict of preferences: Inflation differentials widened dramatically and so did (monetary) policy responses to those shocks.[8]

After the failure of the Werner plan, there were several attempts to limit exchange rate fluctuations between the various currencies of the EC Member States so that intra-European trade and especially the CAP would not be affected: the “Snake in the tunnel”, an experience of joint fluctuation of European currencies (the intra-European fluctuations were limited to +/- 2.25 per cent) vis-à-vis the dollar, which lasted only for one year (from March 1972 to April 1973); the “Snake out of the tunnel”, after the various European central banks

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[6] Ungerer (1997: 114) refers to France’s rejection of an early commitment to the concept of common policy making and German and Dutch requests for more consideration of the supranational aspects of the Werner Report.

[7] As noted by Thygesen (1996), protectionist pressures in a monetarily fragmented system would include industrial subsidies in strong-currency countries.

[8] For an analysis of those circumstances, see Verdun (2000).

stopped defending the parities of their currencies in relation to the dollar and the experience of joint fluctuation after which a de facto Deutschmark area extending to the Benelux and the Nordic currencies was established. The failure of the snake was also marked by the lack of convergence of preferences.

The European Monetary System (EMS) appeared in March 1979[9] as an urgent political compromise which was only possible because of the way in which it was initially promoted in 1978: at the highest political level and "outside the routine framework for discussing such issues in the EC".[10] In contrast to the Jenkins proposal,[11] which very much embraced the approach of the McDougall Report,[12] it did not envisage any policy coordination outside the monetary area. Although the EMS was not presented as a device aimed primarily at reducing inflation (as argued by Della Posta, 2007), since otherwise the choice of symmetry would not have been made, (overcoming) different preferences about inflation may have already been a central issue in (and motivating) the Giscard-Schmidt political initiative (compromise).[13] Inflation differentials between Germany and other European countries had shown the incompatibility of different national policies / developments (preferences) and common exchange rate arrangements such as the Snake. Nevertheless, participants understood that they would eventually have to choose between floating (that is, too frequent realignments) and fixed exchange rates with a convergence of preferences regarding the inflation rate. Institutions could provide policy makers with effective constraints.

By the time of the Delors report in 1989, the EMS was already clearly perceived (almost exclusively) as an anti-inflationary / disciplinary mechanism. However, in the wake of the Werner Report,[14] whose recommendations had been adopted as objectives of the European Community in March 1971, the Delors Report – or more precisely the Report by

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[9] In the First Jean Monnet lecture at the European University Institute, the then President of the European Commission, Roy Jenkins, re-launched the idea of a new phase of European monetary cooperation and may have set the basis for the Franco-German initiative (Schmidt - Giscard d'Estaing) on which the EMS was built.

[10] Gros and Thygesen (1998: 35). See Ludlow (1982) for an earlier analysis of the making of the EMS and Gros and Thygesen for a brief history and detailed analysis of its functioning.

[11] Jenkins (1977).

[12] McDougall et al. (1977).

[13] Among the motivations for the creation of the EMS, however, Jenkins also included the need to reduce inflation. In the earlier famous All Saints' Day Manifesto (Basevi et al., 1975) that proposed a parallel currency, the Europa, with constant purchasing power, the fight against inflation was also very much a preoccupation, and was clearly highlighted as a stated objective.

[14] Werner Committee (1970).

the Committee for Economic and Monetary Union[15] – adopted a gradual strategy in the transition to a European single currency. The definition of Economic and Monetary Union entailed respect for the conditions established in the Werner Report: the irreversible convertibility of all currencies and the full integration of the financial system, as well as the elimination of the fluctuation margins and the irrevocable fixing of exchange rate parities.

The IGC was convened at the end of 1990 and continued until the Maastricht summit. Its goal was to guarantee the irreversibility of the process of building up a true economic and monetary union (EMU). The single currency again constituted the logical corollary of the single market[16] but was also the first step towards increased political integration – monetary affairs were again perceived as a powerful engine for further political integration.[17] This time, however, there was a consensus on the main objectives and institutional design of EMU.

The remainder of this paper is organised as follows: in the next section I present the two main views on what the objectives of Economic and Monetary Union should have been and how it should have been implemented; section 3 analyses how initial different and opposing views on European monetary integration and on the role of monetary policy did not allow for an earlier establishment of EMU (with the failed attempts of the Werner plan and the Snake). Section 4 discusses the political compromise found for the creation of the EMS and how that system changed in nature over the years. Section 5 addresses the convergence of preferences of the two main views on European monetary integration during the second phase of the EMS. Section 6 examines the exchange rate crisis of 1992/93. Section 7 analyses the compromise reached at Maastricht on the basis of the previous convergence of preferences. Section 8 offers some conclusions.

2. The two main views on the monetary future of Europe

From the beginning of the debate on Economic and Monetary Union there were two main divergent views (or camps) on how to coordinate monetary policies and on the

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[15] Delors Committee – Committee for the Study of Economic and Monetary Union (1989). The Committee was created in June 1988 at the Hannover Summit and its report came out in April 1989.

[16] Emerson et al. (1990).

[17] Torres and Giavazzi (1993).

need to achieve monetary integration in Europe. The debate pitted the so-called monetarists, who thought that monetary integration would promote economic (and indeed political) convergence, against the so-called economists, who stressed the need for a higher level of coordination of economic policies and integration prior to the establishment of a monetary union, that is, for some prior convergence of economic (and necessarily political) integration.[18] These divergent views amount to two different approaches on two distinctive levels:

The first point of contention concerned the nature of the transition to EMU, i.e. whether it should be more immediate or more gradual; a second point of dispute centred around divergent preferences on the role and institutional design of monetary policy, namely on the degree of centralisation and independence of monetary policy required to guarantee price stability.

Such a role and design were clearly not independent of the degree of economic and political integration which was necessary in order to share monetary sovereignty, which in turn conditioned the way in which the transition to EMU could be made.

As far as the first level (views on the transition) was concerned, the so-called monetarists (notably France, Belgium and Luxemburg and eventually also Italy, whose position was less clear-cut) adopted a functionalist view of European integration insofar as they perceived monetary cooperation, such as the narrowing of fluctuation bands or mutual credit lines, as a means of bringing about economic and political integration, without surrendering too much of their political sovereignty. As for the second level (views on monetary policy), the building up of economic and monetary union would be very much an open ended strategy to solve problems as they would appear and one which contributed to a deeper step-by-step political integration. This approach to monetary integration corresponds very much to a functionalist view of European integration.

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[18] Describing the controversy over the Maastricht convergence criteria, Wyplosz (2006) classifies these two old labels as bizarre, questioning the reasons behind them. In this paper I go beyond the established definitions of those two labels (see for instance Ungerer, 1997) and try to reinterpret the positions from the perspective of what happened during the experience of the EMS, and thus draw parallels with two other currents of opinion as far as the overall process of European integration was concerned. The label "monetarists" (not to be confused with the doctrine on the quantity theory of money) encompasses the view that a tight and unconditional agenda is needed for the creation of common monetary institutions, as an open-ended way not only of responding to the monetary problems of the moment but also of driving political integration, given that heightened economic integration and new institutions reflecting heterogeneous preferences would lead to a higher degree of political integration (compatible with a functionalist view). The "economists" may justify their label by advocating a prior convergence of economic developments and/or of preferences regarding a culture of (price) stability (compatible in a less obvious way with a federalist view).

On the other hand, the so-called economists (by and large the Germans and the Dutch) argued that economic convergence and close coordination of other policies such as fiscal and wage policies would have to come first. As for the second level (views on monetary policy), they would only agree to move on to Economic and Monetary Union (EMU) after making sure that there had been a prior convergence in terms of economic developments and/or the previous establishment of a federal institution with well defined objectives. This position can be described as a federalist view of European integration insofar as their proponents would advocate the creation of new common supranational institutions with clearly defined goals for which there was a need for prior agreement.

At first glance, the requirement of a prior convergence in terms of economic developments might seem contradictory (as argued by Della Posta, 2007) with respect to an institutional approach setting up the appropriate rules for the automatic attainment of a non-inflationary environment that is also more conducive to long term growth. Of course the prior convergence of economic developments as a political requirement amounts very much to a step by step (gradualist) approach and does not necessarily ensure a genuine convergence of preferences nor the sustainability of new common rules.[19] Only institutional arrangements, such as the rules governing the ECB, would guarantee that all EMU members abided by a common preference for low inflation for the entire eurozone. However, such a prior (entry) requirement, understood as a test for a genuine convergence of preferences, is compatible with a federalist view and the defence of new institutions with clearly defined political objectives (basically, a monetary constitution). Considered in the perspective of different but converging preferences, it may also be easier to comprehend the coherence of the different positions as far as EMU is concerned throughout recent decades and the rationale behind the compromise reached at Maastricht.[20]

The Werner plan and the experience with the Snake clearly show that the preferences between the two camps were too different for a compromise to be possible. However, the creation of the EMS indicates some increased flexibility (in the context of re-launching Franco-German cooperation[21]) on the part of both camps, which boils down

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[19] De Grauwe (1996).

[20] Torres (1996 and 2007); Wyplosz (2006).

[21] For different explanations of the importance of Franco-German cooperation throughout the process of monetary integration and on the implications of such integration and of the ensuing economic convergence of the two countries for that relationship, see Collignon (2004) and Jones (2002).

to the creation of a temporary and open-ended institution. This implied delaying discussions about preferences over the goals of monetary policy.

The EMS was then possible (although with the opposition of the Bundesbank[22]) as a way to solve immediate problems (see below), leaving the door open for realignments whenever monetary policy goals (preferences) were not compatible. Eventually, during the second phase of the transforming EMS, when it became essentially a Deutschmark zone, preferences between the two camps converged significantly. This made it possible to agree on a blueprint for Economic and Monetary Union, with clearly defined goals to be implemented by a common federal institution.

Again, in the transition to EMU another compromise was struck. On the one hand, the "monetarists" received a tight and quasi-irreversible agenda (with a very precise calendar) also in order to anchor post-reunification Germany to the European Union. On the other hand, the "economists" established the entry criteria and the stability and growth pact as what they saw as a guarantee for a prior and genuine convergence of preferences, or at least as a means for addressing the potential opposition of German public opinion to the loss of the Deutschmark. This compromise was clearly political but does reflect a true convergence of preferences over the years.

This paper argues that, rather than distinguishing between the EMS and EMU in terms of Keynesian or monetarist (opposing and contradictory) theoretical foundations,[23] the different unsuccessful political attempts (Werner plan, Snake) and successful political compromises (EMS, EMU) can be explained in terms of convergence of preferences over time, tempered of course by the circumstances of each political and economic phase of European integration and the corresponding bargaining power of each camp.[24]

3. Earlier plans for Economic and Monetary Union

In the Werner report the main objective of the European Economic Community (EEC) seemed to be to achieve the political independence of Europe in monetary affairs.

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[22] The Bundesbank feared that the arrangement could condition its very monetary policy and could not show as much flexibility as the German government, which also considered other political goals besides price stability.

[23] As in Della Posta, (2006 and 2007).

[24] This view may help us better to understand the political sustainability of EMU, as preferences might converge or diverge depending on its very functioning. See Torres (2007a and 2007b).

Conflicts over the course of monetary policy were already undermining the good functioning of the Bretton Woods system, with the US becoming an increasingly reluctant leader. The project of monetary unification in Europe envisaged by the Werner Report involved the creation of an area in which goods, services, people and capital would circulate freely and without competitive distortions and thereby reinforce the EC contribution to an economic and monetary equilibrium in the world.[25]

When the Werner Report was written, the Bretton Woods system was still operational but the devaluation of the British pound in 1967 and, more importantly, the devaluation of the French franc in August 1969 had already greatly affected intra-European trade and, in the latter case, the functioning of the CAP.[26] Those preoccupations, which were subsequently very much at the basis of the more urgent decision to create the EMS, only partially explain the project of European monetary integration as outlined in the Werner Report: the apparent fragility of the international monetary system and the evolving discussions over its reform made it imperative for the EC to establish a coordinated position on a global level.[27]

We can therefore conclude that the main motivations of the Werner Report involved the perceived need to improve the coordination of economic and monetary policies world-wide and in the European Community (EC) in order to ensure the implementation of a common market and the proper functioning of the CAP.

By this stage, as far as Germany was concerned a European monetary union would have to have an independent European central bank basically modelled on the Bundesbank.[28] In fact, as noted by the German negotiator on the Werner committee, a European monetary union would need to establish clear rules so that external commitments involving a reduction of the member states' autonomy in economic policy should be made only if the necessary harmonisation or integration of economic policies could be ensured.[29] This position would satisfy the requirements of other countries,

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[25] Werner Committee (1970: 9).

[26] Giavazzi and Giovannini (1989) and Gros and Thygesen (1998) provide for an excellent account of these events.

[27] See Ungerer (1997).

[28] Zimmermann (2004).

[29] See Zimmermann (2004) for a citation of the precise wording used by the German negotiator in the Werner committee, J. Schöllhorn, in his Memorandum on EMU, 23/4/7, 0PA-AA, IIIA1, vol. 590. According to Zimmermann, after making the initial proposal Chancellor Willy Brandt focused on

including in particular France, which would like to preserve more active monetary policies. In consequence, the Werner plan for an economic and monetary union did not progress.[30]

4. The EMS as an open ended compromise

Reflecting a functionalist approach to European integration and the perspective of the so-called monetarists (France, Belgium and Luxemburg), the EMS began to operate in 1979. During the first years of its life it worked just as an adjustable exchange rate mechanism aiming at limiting exchange rate fluctuations but allowing for the compensation of inflationary differentials that would have affected the competitiveness of a country. This is why almost automatic exchange rate realignments were allowed during the first years of the EMS' existence.

In fact, during a first phase, between 1979 and 1983-84, the EMS was still characterised if not by symmetry than at least by frequent realignments which would allow for the accommodation of inflation differentials through devaluations of the weaker currencies (their central parities) in order to compensate for the corresponding loss of competitiveness. From the mid-1980s however, and up until the exchange rate crisis of 1992-93, the EMS essentially became an asymmetric mechanism, a Deutschmark area, with fewer (and smaller) realignments, which would allow only for the partial accommodation of inflation differentials.[31] Starting from a mechanism of exchange rate stability (with many adjustments) the EMS became a disciplinary mechanism.

This change in the nature of the EMS, from a symmetrical arrangement to an asymmetric arrangement anchored in the Deutschmark, was caused by a convergence of the preferences of policy makers and politicians from the different participating countries. Below I discuss two principal explanations for this convergence of preferences in favour of price stability vis-à-vis other objectives of economic policy.[32]

Ostpolitik, thereby allowing the Economics Ministry and the Bundesbank to represent the German view on EMU.

[30] See Gros and Thygesen (1998), Ungerer (1997) and Zimmermann (2004) for a thorough analysis of the failure of the Werner plan.

[31] See Torres (1987) for a more detailed analysis and a graphical representation.

[32] Another important factor involves the changes which occurred in international politics, namely with the so-called conservative revolution, initiated by Margaret Thatcher in the United Kingdom and by Ronald Reagan in the US and the consequent establishment of "*supply-side economics*" and monetarist doctrines. Those doctrines banned the use of stabilisation policies for structural purposes and favoured price stability over other goals of

5. The main factors contributing to the convergence of preferences in the EMS

5.1 Changes in domestic and European policies and politics

The first of these factors concerned two important policy and political changes, one in France and the other one in Italy.[33] France under its first post-war socialist government had opted for counter-cyclical expansionary fiscal and monetary policies encompassing higher minimum wages, reduced working hours and several nationalisations. As a result, the franc was forced to devalue each year from 1981 to 1983 against the Deutschmark. President Mitterrand had failed to go his own way and, inspired by his finance minister, Jacques Delors, decided to reshuffle his cabinet, substituting a policy of competitive devaluations for a policy of competitive disinflation – the "franc fort" policy was born. France also came to accept what it had not accepted in the compromise that established the EMS, namely a surrender of its monetary sovereignty and follow the anti-inflationary policy of the Bundesbank, re-launching at the same time the engine of Franco-German integration (now with Mitterrand and Kohl instead of Schmidt and Giscard d'Estaing). Italy took a bit longer but in 1985, when the lira was forced to devalue again against the mark, the wage indexation mechanism, known as the *scala mobile,* was abolished with a view to breaking the wage-inflation spiral. This represented a true change of regime, which became possible thanks to a national referendum held in 1984.[34] Italy and France would still carry out two general realignments in 1986 and 1987, but with much smaller devaluations against the Deutschmark, after which their currencies were pegged to the ECU and all the other

economic policy. Prior to these changes and to the projection at the highest political level of those economic doctrines, and in spite of the abandonment of the idea of a monetary union in Europe, the academic debate on monetary integration was revived with the end of the Bretton Woods system and in the aftermath of the first oil shock. A high point of that debate was the All Saints' Day Manifesto (already mentioned above), published by The Economist on 1 November 1975 – the same day on which the Maastricht Treaty entered into force in 1993 – by a group of European economists (Basevi *et al.*, 1975), proposing the introduction of a common currency, the 'Europa', and the discussion that the proposal precipitated.

[33] According to Quaglia and Maes (2004), the lack of convergence of France and Italy with Germany in the process of European monetary integration was mainly explained by the difficulties to accept a common and independent European central bank and by problems in achieving macroeconomic stability, respectively.

[34] For more details see Gros and Thygesen (1998: 82).

currencies participating in the Exchange Rate Mechanism (ERM) of the EMS from 1987 until the ERM crisis in 1992-93.[35]

These policy and political changes in France and Italy and also in several other countries need to be put in the context of domestic political struggles between stability-oriented national central banks and treasuries and non-stability oriented spending ministries and politicians constrained by the political business cycle. These domestic struggles can help us better understand the changes which occurred. Stability-oriented policy makers rightly anticipated that those changes would also transform the EMS into an external constraint – a guarantee of monetary, and hopefully budgetary, discipline.

5.2 Changes in economic thought: A new theory of economic policy

Second, there was also a revolution in economic thinking - the rational expectations revolution - consisting in the assumption that economic agents were rational (which led to the award of the Nobel Prize to Robert Lucas in 1995 precisely for having developed and applied rational expectations and by having thereby transformed the understanding of economic policy), drawing attention to the costs in terms of inflation and unemployment of the lack of credibility of policy makers in relation to economic agents (which led to the award of the Nobel Prize to Finn Kydland and Edward Prescott in 2004, for their analysis of the time inconsistency of economic policy). The profession's recognition of the relevance of the study of institutions, and how they affect economic performance (as pioneered by Douglass North, Nobel laureate in 1993), and of non-cooperative games (as pioneered by John Harsanyi, John Nash and Reinhard Selten, Nobel laureates in 1994) also shows a growing consensus over the importance of adequate rules and well-designed institutions for economic performance.

Governments, besides being subject to constraints over their lack of knowledge about the functioning of the economy, also work under explicit credibility and political constraints. As a result, policies are the outcome of the government's optimisation problem: the maximisation of a well-specified objective subject to these binding

[35] There was only a technical realignment in 1990 which involved the rebasing of the central rate for the lira that moved into a narrower fluctuation band.

constraints. This approach[36] translates, in the literature, into a number of positive models of economic policy in alternative institutional settings. These different environments vary from monetary and/or fiscal regimes and reforms (which in general parallel rules versus discretion) to changes in government colour and organisation (elections, simple majority, multi-party coalitions, etc.) and determine the credibility and political constraints that policy makers face. Credibility constraints are related to the temptation of policy makers to deviate from pre-announced plans, without disagreement over the ultimate policy goals. Political constraints involve conflicts of interest over those goals.

Although the two aspects are in general separated for the sake of presentation, it is their interplay that forms the basis for the theory and practice of economic policy. Credibility literature stands by itself as a distinct body even without any particular focus on politics: it started with the initial work on time-inconsistency referred to above and gained shape with the seminal paper by Barro and Gordon[37] on rules and reputation as possible solutions to that problem. Many developments of these ideas took place within the framework of game-theory and reputation models. The idea of binding political constraints stems from the political business cycle literature (where governments have incentives to behave opportunistically – basically in order to be re-elected and remain in power) and from the theory of public choice (where there are conflicting policy preferences among different interest groups).

The lack of a safe commitment technology without formal rules has led to normative prescriptions, resulting from positive models of economic policy. These ensuing recommendations deal with institutional (re-)design (such as the delegation of monetary policy to independent central banks, constitutional rules on balanced budgets, etc.) and not with specific policy rules; they aim to change political equilibria (the incentive constraints faced by policy makers) which may alter policy outcomes.

In the mid-1980s, the academic interest in new proposals for a European monetary union gained a new impetus thanks to the internationalisation of the profession in Europe, namely through newly established networks such as the London-based Centre for Economic Policy Research, whose macroeconomic group frequently brought together in different

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[36] For a discussion on credibility and political constraints in the context of EMU see Torres (1992) and (2006). While credibility constraints were dealt with by the establishment of an independent European central bank with the primary objective of price stability, political constraints are more difficult to address and involve the question of the accountability of the monetary authorities (an issue that deserved more attention in the Werner Report than in the Delors Report, composed essentially of central bankers).

[37] Barro and Gordon (1983).

conferences and seminars economists and high officials from national central banks and treasuries and the European Commission. Academics (political economists) saw the context of an enlarged market and potential institutional reform in Europe as an excellent opportunity to study the role of institutions in economic performance from a political economy perspective.

The time inconsistency literature suggested that exchange rate realignments could undermine the anti-inflationary credibility of a country. The interaction of the academic world with policy makers proved to be very powerful in shaping a new consensus on the best rules for monetary policy in Europe, namely in favour of using the EMS as a disciplinary mechanism for high-inflation countries and as a way of enhancing central bank credibility, and moving opinion in favour of Economic and Monetary Union.

In this context, the paper presented by Giavazzi and Pagano in 1986 at the European University Institute stressed the usefulness of EMS discipline as a means of effectively reducing inflation with a lower cost in terms of output and unemployment.[38] Fixed exchange rates, unlike other policy targets, can easily be tracked by the private sector and easily implemented by the authorities. With a credible exchange rate peg to a strong currency (such as the Deutschmark), the monetary authorities of higher-inflation countries could drawn on the anti-inflationary reputation of the strong currency country (Germany) so as to strengthen the credibility of national institutions and modify the expectations of private agents. In this way the authorities of the higher-inflation countries raised the political costs of inflation because their anti-inflation commitment was constantly monitored by the private sector and any different behaviour would imply a self-inflicted loss of competitiveness, which thus made the peg credible.

As argued in previous studies,[39] Giavazzi and Pagano's contribution was one of the most influential academic contributions leading to the creation of a consensus (and epistemic communities) in favour of EMU.

By the late eighties and early nineties a general consensus had been established among economists but also, in part thanks to the networks mentioned above, among policy makers (i.e. members of the monetary committee and national central banks and

[38] Giavazzi and Pagano (1998).

[39] Torres (2006 and 2007a).

treasurers which may have constituted an epistemic community[40] in favour of sound rules to guarantee price stability), the private sector and eventually also politicians, on the need to radically change the attitude towards inflation. There was also a relative consensus among those actors on the powerful disciplinary and disinflationary role of the EMS. This was due to the fact that the EMS had changed in nature from a symmetrical monetary arrangement to a Deutschmark zone.[41]

6. The exchange rate crisis of 1992/93

Such a growing consensus may have contributed to the stability of the EMS between 1987 and 1992. There were no realignments, except for a technical adjustment of the lira to a narrow band of fluctuation in 1990, and policy makers got used to the idea of living in a system of irrevocably-fixed exchange rates.

The EMS had worked relatively well with capital controls, making it possible for the "followers" of Germany to adjust their exchange rates (through a realignment of the central parities of their currencies). However, this was no longer possible following the creation of the Internal Market in 1992 and the consequent elimination of all capital controls. The end of capital controls, an efficiency objective of the Single Market Programme, brought with it the possibility of exchange rate speculation against all the currencies susceptible to devaluation.

When a typical asymmetric shock such as German reunification occurred in 1990, policy makers and politicians remained firmly committed to fixed exchange rates in order not to lose credibility. A revaluation of the Deutschmark against all other currencies could have been the textbook answer to such an asymmetric shock. Yet the other EMS members

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[40] See Haas (1992: 3) for a definition of epistemic communities. Collignon and Schwarzer (2003), who also provide an excellent discussion on how epistemic communities create consensus and a thorough discussion of the concept and the definition mentioned above, apply this concept to the private sector, namely to two important non-governmental organisations representing the views of the business and banking communities that took a very active role in favour of a European monetary union: the Giscard-Schmidt Committee for the Monetary Union of Europe (CMUE) and the Association for the Monetary Union of Europe (AMUE). See also Verdun (1999) for an application of the concept to the Delors Committee.

[41] According to Mundell (1994), the exchange rate mechanism (ERM) within the EMS in theory was symmetrical with respect to its member countries, but in practice the Deutschmark became the "inflation anchor" of the system. In my opinion, further developments of the theory strengthened (Torres, 1996 and 2007a) the superiority of rules versus discretion although this is controversial (see Della Posta, 2007, for an opposite view) and a discussion beyond this paper, where I just discuss how the prescription of exchange rates and/or monetary rules led to the creation of a political consensus in favour of EMU and the compromise reached at Maastricht.

resisted that possibility, fearing a loss of the credibility gained over the previous years inside the EMS.

Given the existence of free capital mobility, the markets could easily test the commitment of each one of the other EMS members regarding their degree of adherence to the German tight monetary stance. The British pound and Italian lira, which were considered by the markets to be strongly overvalued in real terms, were forced out of the system by two speculative attacks whilst all the other currencies remained in the system, although the EMS fluctuation bands had to be enlarged less than a year later.[42]

Following the enlargement of the fluctuation bands, exchange rates remained rather stable within informal and rather narrow bands for most currencies (except for the pound and lira that had left the ERM), since there was no formal commitment to be tested by speculators. The enlargement of the fluctuation bands did not imply an abandonment of the anti-inflationary stance in most EU countries, as they maintained, and in some cases even accelerated, the pace of convergence with Germany in order to satisfy the approved nominal convergence criteria established in the Maastricht Treaty.[43]

As a matter of fact, fixed exchange rates and the commitment to the Internal Market objective of liberalising all capital movements implied the end of any monetary policy autonomy for the "followers" of Germany. The only chance to hold on to any monetary sovereignty was to share it in a common institution such as a European central bank.

7. The Maastricht gradualism

At Maastricht, all EU countries seemed to have come around to the view that a credible and sound counter-inflationary monetary constitution should be adopted (although not necessarily a European monetary constitution in the cases of the UK, Denmark and Sweden). As has been pointed out in the modern political economy

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[42] For an account of this episode, according to which the British Chancellor of the Exchequer, Kenneth Clarke, had a decisive role, see Collignon and Schwarzer (2003: 122).

[43] This is clear in the policy stances of most EU countries: France achieved lower inflation rates than Germany, Portugal substantially reduced its inflation rate during the exchange rate crisis, and in Italy (see Eichengreen and Ghironi, 1996) the government agreed with social partners in 1992 and 1993 to do away with still persisting ways of wage indexation. The monetary authorities of all EU countries, including those with an opt-out clause - i.e. the UK Denmark and Sweden - kept following anti-inflationary monetary policies after the exchange rate crisis of 1992-93 as part of their commitments to nominal convergence.

literature, joining a monetary union based on institutions that deliver price stability is probably the best way to implement such a strategy.

In that perspective, there would be a tendency for high inflation countries to gain more than low inflation countries by sharing their monetary autonomy in a common monetary institution. The problem therefore became that of motivating countries that already had credible monetary institutions and hence low inflation to share their monetary autonomy with recently converted higher inflation countries that might resort to their old (inflationary) habits. The reluctance of low inflation countries to associate with countries with no prior solid record on price and monetary stability is an offshoot of such concerns. This is why the German central bank was perceived as reluctant to embark upon the project of European monetary integration. It was also for this reason that the October 1993 ruling of the German Federal Constitutional Court, the *Bundesverfassungsgericht*, made it possible for Germany to pull out of EMU if it could not deliver monetary stability. The Maastricht gradualism was justified on the grounds that the convergence of macroeconomic variables was a pre-condition for EMU and that time would be needed to set up new European monetary institutions.

EMU (like the Werner plan 20 years earlier) met with the reluctance of the Bundesbank to relinquish its powers to less solid European monetary institutions, with the corresponding ramifications for domestic politics in Germany. The idea that the adoption of a single currency should be accomplished swiftly rather than gradually was defended by the "monetarists" (especially France). The position of the "economists", voiced by Germany's foreign minister Hans-Dietrich Genscher when he was also president of the EC General Affairs Council in 1988, seemed to agree on the need to complement the internal market with a European monetary union and a European central bank. They however also stressed the need for a prior agreement on the basic economic policy principles, the "*ordnungspolitische Grundauffassungen*", of a monetary union: the existence of an autonomous European central bank whose policies would primarily aim at price stability and which would be free from any obligation to finance national or EC budget deficits.[44]

Although by the early 1990s most EU countries had agreed to most of these aims, not all of them were ready (i.e. had fulfilled the convergence criteria) for monetary union in 1999. Therefore, a variable geometry emerged as a possible approach to EMU that

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[44] Ungerer (1997: 197).

would safeguard Germany's position. However, in the case of a multi-speed EMU, macroeconomic convergence would become even more difficult for the countries which were catching-up, since their exclusion from EMU's third phase would automatically render them more vulnerable in the international financial markets. As a result, by the simple fact of being perceived as laggards, these countries could have experienced speculative attacks on their currencies that would distance them further still from the Maastricht entry requirements. To complicate matters, the core members might then become reluctant to enlarge the union.[45]

A multi-speed Economic and Monetary Union (or, a more extreme eventuality, the failure to establish EMU) could then imply a serious set-back in both the on-going process of monetary integration and the EU's level of economic integration. The European exchange rate crisis of 1992-93 and the 1995 aftermath of the Mexican crisis provided good illustrations of this. Moreover, the internal market would be threatened if there were serious currency misalignments that would give rise to trade protectionism. This was a powerful argument in favour of resisting any delays to the transition to EMU too much. It was non trivial even for Germany[46] and may have answered some of the reservations regarding EMU on the part of some German politicians (such as Edmund Stoiber and Gerhard Schröder).[47]

The Maastricht Treaty then established a calendar for the various stages of monetary integration and a set of conditions for the macroeconomic performance of future members of EMU, as well as a constitution for the future European monetary authority, the European Central Bank (ECB).

The first phase of monetary integration started well before the Treaty on European Union entered into force on 1 July 1990, with the liberalisation of capital controls.[48]

The second phase of monetary integration, whose interest and implications (potential instability) precipitated intense discussions during the elaboration of the Delors Report and the preparation of the Intergovernmental Conference that gave rise to the Maastricht

[45] See Alesina and Grilli (1994) for a formal analysis of this point.

[46] See Eichengreen and Ghironi (1996).

[47] As it is generally held that the Deutschmark might have appreciated substantially in the absence of EMU, the Euro may have also been perceived as advantageous for the German economy, namely for the car manufacturing and milk production sectors.

[48] Ireland, Portugal and Spain liberalised all capital controls before the 1992 deadline for the implementation of the Single Market while Greece relied on its derogation until 1995.

Summit, started in 1994, slightly later than the planned date (1 January 1994). A European Monetary Institute (EMI) was created, the precursor of the future European Central Bank, whose functions were outlined as accompanying the second phase of EMU (the meetings of the central bank governors of the countries of the Union started to take place in an institution of the European Union, the EMI headquarters in Frankfurt rather than in the headquarters of the Bank for International Settlements in Basle), that is, the facilitation of monetary cooperation between national central banks within the context of the ERM of the EMS and the promotion and supervision of the ECU, and preparation for the switch to the third phase of EMU – the creation of the European System of Central Banks (ESCB) and the adoption of the common currency. The EMI was totally dependent on national central banks in budgetary terms and was staffed essentially by technical officers from those banks.

In addition to the technical preparation for the entire process of the creation of a central bank and a common currency, along with the necessary adaptations of national legislation (such as the statutes of the various central banks), the second phase of EMU also served to facilitate the increasing nominal convergence between member states. Therefore, "at the latest until 31 January 1996", the EMI would define the necessary administrative, organisational and logistic framework for the ESCB to fulfil its tasks in the third phase (Article 109F(3) of the TEU).

The third phase of EMU was scheduled to start on 1 January of 1997 or at the latest on 1 January 1999 and to include those countries which had fulfilled the convergence criteria (Article 109J(3) and (4)). Any countries which did not satisfy the convergence criteria benefited from a derogation (Article 109K(1)).

7.1 The Maastricht convergence criteria as a political compromise

From a strictly economic point of view, waiting for the convergence of economic conditions to form a monetary union did not make sense. In fact, according to some authors, including for instance De Grauwe,[49] the gradual approach inscribed in the Maastricht Treaty was nothing but a mechanism for delaying a political conflict between the German (i.e. Bundesbank) preferences not to share monetary sovereignty in EMU and the French preferences for a larger influence in European monetary affairs. In fact, from an economic viewpoint, it would make sense to allow high inflation and/or high debt countries into

[49] De Grauwe (1993).

EMU, provided that they had decided to participate in any case, so that it would be easier (in other words less costly) for them to reduce inflation and their public debt ratios. This is because the institutional differences, reflecting different preferences that imply different inflation and interest rates, would then disappear. Therefore, it would have been sufficient to guarantee an adequate institutional design of the European Central Bank (ECB) so that it could fulfil its task of assuring price stability and resist any pressures to accommodate problems in the area of public finance.

Nevertheless, convergence requirements were imposed in order to show the commitment to a culture of price stability. Criteria on the convergence of long-term nominal interest rates and ERM membership reflected the view that countries had to convince the markets of their determination to maintain an anti-inflationary stance.[50] Fiscal criteria were motivated by the idea that some prerequisites in the area of public finance would provide an incentive for fiscally-weak countries to avoid politically motivated deficits that could endanger, through the insolvency of the respective public sectors, the monetary stability of the entire union.

Rigid fiscal rules however, would not allow for tax-smoothing in the presence of transitory shocks, thus preventing governments from running adequate deficits during recessions.[51] The idea that fiscal policy should play a greater role in cushioning the impact of shocks is best reconciled with the convergence requirements set out in the TEU (according to which national fiscal policies are constrained by binding rules), especially in the light of the fact that the level of public deficits in the early 1990s was extremely high throughout most of the countries of the European Union.[52] The compromise involved a rapid leap forward to a one-speed monetary union entailing a number of entry requirements which would test whether (or show to those opposing EMU that) there was a “sufficient” prior convergence of preferences.

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[50] Baldwin and Wyplosz (2006).

[51] Corsetti and Roubini (1993) provide an analysis of this trade-off between the benefits of fiscal rules and the possibility to use fiscal policy as a stabilisation instrument. They also provide a good survey of the political determinants of budget deficits. See also Jones (2007) for a discussion on the role of fiscal stabilisation in EMU.

[52] Interest rate payments on public debt amounted to 40 per cent of total household savings in Europe, hitting private investment and jeopardising the financing of social protection.

8. Concluding remarks

The construction of EMU is to a large extent characterised by the convergence of preferences on the role of monetary policy and institutions, namely on the weight attached to the objective of controlling inflation. The Maastricht blueprint reflects a compromise between those converging views in the context of several changes that took place in the early to mid-eighties.[53] Inflation is of course central to understanding the economic and political reasoning behind Maastricht, as the divide between anti-inflation and accommodating monetary authorities, which led to the failure of the Werner plan and of the first asymmetric arrangements of EC monetary cooperation (the Snake), further widened in the 1970s.

An exchange rate regime characterised by fixed parities and complete freedom of capital movements was not compatible with the maintenance of the monetary autonomy of national central banks. After the liberalisation of capital movements, and in the context of the changes which occurred in the International Monetary System (the end of the Bretton Woods system) and in the EMS, which was an initially open ended political compromise of different views about inflation and the role of monetary policy and institutions that transformed into a Deutschmark area, the only way of maintaining any influence over the course of monetary policy involved the pooling of sovereignty in the context of decisions taken by a common central bank.

The establishment of a timescale for the creation of EMU institutions was an expression of the determination to draw Germany into an increasingly broader participation in the European institutions and a leftover of the "monetarist" view. The gradualist approach to EMU and the established preconditions (convergence criteria) for the creation of a European central bank responsible for the monetary policy of the entire Union reflected, for its part, the pressures exerted by Germany for a delay in the transfer of its sovereignty to the ECB, and could also be considered as a remaining echo of the "economists" view. However, the plans for a monetary union envisaged by the Delors Committee would not have materialised, even less so in the more ambitious version enshrined in the Maastricht Treaty, had the different preferences on inflation and on the role of monetary policy and institutions not genuinely converged during the 1980s.

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[53] McNamara (1998) and Della Posta (2006) refer to the emergence of a monetarist consensus in Europe by the end of the 1980s, when the EMS experienced a period of success and prolonged stability. In this paper I have tried to explain the factors that led to a convergence of preferences in favour of price stability.

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