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## Economic and monetary union: from 1957 to the euro crisis

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► **To cite this version:**

Alexis Drach. Economic and monetary union: from 1957 to the euro crisis. Brigitte Leucht; Katja Seidel; Laurent Warlouzet. Reinventing Europe: The History of the European Union, 1945 to the Present, Bloomsbury Academic, pp.183-202, 2023, 978-1-350-21308-1. hal-04475213

**HAL Id: hal-04475213**

**<https://hal.science/hal-04475213>**

Submitted on 23 Feb 2024

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## **Chapter 10: Economic and Monetary Union: from 1957 to the euro crisis**

*Alexis Drach*

### **Introduction**

The euro crisis that started in November 2009 has triggered much debate over the extent to which the Eurozone was viable.<sup>1</sup> While the wider public mostly heard about indebted countries, and of the risk of default, most specialists stressed that the crisis revealed structural weaknesses of the Eurozone (Claeys 2017). The whole architecture of economic and monetary union (EMU) has since come under intense scrutiny. But what does ‘economic and monetary union’ exactly mean and why was it created? Independent states willingly surrendering their own currency and adopting a common one is a rather rare event, because monetary policy forms an important part of sovereignty. Although monetary measures seem very technical, they are very much embedded in the political, economic, and social context of the time. Monetary policies have close links with credit policies, budgetary policies, employment policies, banking supervision and regulation, and international relations, and member states of the European Union (EU) have always been tempted to preserve their individual national interests, in particular in times of crisis.

While some scholars have emphasized the role of the ‘founding fathers’ of the euro in the creation of EMU (such as Robert Marjolin, Pierre Werner, Jacques Delors, or Tommaso Padoa-Schioppa, to name but a few), others have underlined the importance of other actors, such as experts, national and European civil servants, or central bankers (James 2012). Economic and monetary union encompasses all the policies that EU policymakers enacted to make the adoption of a single currency (the euro) possible and to support its functioning. The ‘E’ in EMU, that is the

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<sup>1</sup> This chapter is building on a project that has received funding from the European Research Council (ERC) under the European Union’s Horizon 2020 research and innovation programme (grant agreement No. 716849). The project is entitled ‘The Making of a Lopsided Union: Economic Integration in the European Economic Community, 1957-1992 (EURECON).

economic dimension of monetary union, is often forgotten in accounts of European monetary integration. It refers to areas that European policymakers considered fundamental for the proper functioning of a single currency area. It includes the coordination of member states' budgets, financial transfers within the Eurozone, and the coordination of national banking regulatory and supervisory systems. Monetary affairs closely intertwine with other economic affairs, and the proper functioning of a single currency area implies a high degree of economic coordination and integration. This question, however, is not new, and there have long been discussions over the economic prerequisites of a possible EMU in the European Economic Community (EEC). This chapter will show that monetary issues *and related economic* questions have come a long way in the history of European integration, and have been through many crises and disputes. Member states have, in particular, disagreed on key economic and monetary policy choices. The chapter will explore the various reasons why European policymakers adopted an economic and monetary union and how it evolved since its adoption. It will first analyse the early projects for monetary union in the 1960s and 1970s, then examine the road to the Maastricht Treaty which marked the adoption of EMU, and finally address the eurozone crisis and its consequences.

## **1. Early projects**

The Treaty of Rome establishing the EEC in 1957 did not mention the possible creation of a fully-fledged economic and monetary union. However, it laid the foundations for future progress in the area by calling for a high degree of economic coordination and progressive liberalization of capital flows (Articles 103-9). It also set up a Monetary Committee whose task was to monitor and coordinate member states' monetary and financial policies (Bakker, 1996). Monetary policy, in particular exchange rates, was seen as a matter of common concern to ensure the smooth running of the common market. In addition, important European actors like Jean Monnet (at the helm of the Action Committee for the United States of Europe), Robert Marjolin (a Frenchman who became the

first commissioner for economic and monetary affairs in 1958) and Robert Triffin (a Belgian economist who worked with the latter two) had plans for monetary union in the EEC since 1958 (Seidel 2016). In the 1960s, even though agricultural policy and customs tariffs dominated the integration agenda, European policymakers already discussed the need for increasing monetary cooperation in the EEC. Monetary affairs efforts were primarily geared towards ensuring the proper functioning of the Common Market and the common agricultural policy (CAP): an excessive variation in exchange rates could hamper intra-EEC trade and thereby hamper the objective of the common market (chapters 2 and 8). In the 1950s and 1960s, the international monetary order was governed by the Bretton Woods system, established in 1944, whereby currencies were pegged to the dollar with fixed exchange rates. The system worked relatively well until the late 1960s, sheltering European currency relations from instability. Therefore, the need for further monetary integration was limited.

Article 67 of the EEC Treaty decreed the liberalization of capital flows. In the early years of the EEC, most countries exerted control on capital flows, primarily for monetary reasons, in the sense that these controls existed for fighting inflation or protecting the currency against speculative attacks, but also to limit tax losses. However, not all countries agreed on the desirability and usefulness of these controls: in particular, the German government opposed them because it considered that the absence of controls was better for fighting inflation and saw the freedom of capital movements as a healthy constraint on economic policy. The liberalization of capital flows rapidly progressed in the early 1960s, with two directives in 1960 and 1962, but came to a halt later in the decade. Countries disagreed on the question, and France, in particular, opposed the removal of controls, arguing that it did not want to go further before a clear plan for a European capital market was devised. In 1966, the Segré report, submitted by an expert group chaired by a Commission official, Claudio Segré, provided a roadmap for future reflection on financial and monetary integration in Europe. The end of the decade, however, was not favourable to the liberalization of capital movements. First, several countries had monetary difficulties, which did not

encourage them to liberalize capital movements further. Second, the development of the Eurodollar market (dollars exchanged outside the United States) and the related increase in short-term capital movements raised several challenges. This market escaped EEC governance, as it was mainly hosted in London, and it could have destabilizing effects on monetary policies. Altogether, these difficulties brought plans for further liberalization of capital movements to an end.

The summit meeting of the EECs heads of state and government at The Hague in December 1969 was a landmark in the history of monetary cooperation in the EEC. The customs union planned by the Treaty of Rome had been completed ahead of time, the CAP had been established, and member states agreed that the EEC needed a new impetus comparable to that of the late 1950s. The departure of French President Charles de Gaulle also helped unlock French reservations about the progress of European integration. At the Hague summit, member states agreed to accept three new members, the United Kingdom, Ireland and Denmark as well as moving forward with EMU. EEC member states charged a group chaired by the Luxembourg Prime Minister Pierre Werner to study how an EMU could be attained. In 1970, the group submitted a report known as the Werner Report: it provided a roadmap for attaining EMU by 1980 in three stages.

However, the 1970s brought major changes to the international monetary and economic system. The Eurodollar market was growing fast and was seen to fuel speculation and monetary instability. In August 1971, US president Richard Nixon made a famous speech on TV, stating that because of monetary instability, of the need to fight inflation, and of speculators making a profit on instability, the US would suspend the convertibility of the dollar into gold: foreign governments would no longer be able to exchange their dollars for gold. The end of the convertibility of the dollar was a serious challenge for the Bretton Woods system. Western countries had lived under fixed exchange rates since the war, and the perspective of a floating exchange rate system, even though several economists advocated it, was worrisome to many policymakers. Despite the fact that the US decision was initially temporary, the Bretton System was falling apart. After failed attempts to coordinate with the United States for maintaining fixed exchange rates, European governments tried

to coordinate their monetary policies between themselves. The international monetary upheavals of the 1970s pushed the Europeans to search for a European monetary identity.

The first attempt of EEC countries to respond to these monetary challenges was the establishment of the European monetary 'snake'. The snake was the nickname given to an exchange rate system narrowing the fluctuation margins between European currencies to 2.25% by intervening in the currency market. It was part of the measures contained in the Werner Plan. Initially, the snake was connected to another agreement, made between the so-called Group of Ten (G-10) countries in December 1971, at the Smithsonian Institution, to limit fluctuations of their currencies vis-à-vis the dollar to 4.5%. However, after the final act of the collapse of the Bretton Woods system in 1973, the EEC countries decided to let their currencies float but to maintain the 2.25% (the snake) limit on their fluctuations. The snake faced considerable difficulties because of the period's monetary instability; the burden of adjustment fell on weaker currency countries (France, Italy and the UK). EEC member states also had diverging economic policy orientations (expansionary or disciplinary policies). As a result, the United Kingdom, France and Italy quickly left the system, and the snake essentially became a deutschmark zone. The upheavals of the early 1970s show the interconnectedness of European and global monetary affairs, in particular the link between European monetary affairs and the dollar.

A more successful initiative than the snake was the European Monetary System (McNamara 1998, Murlon-Druol 2012). With the economic crisis following the 1973 oil shock and the failure of the snake in the mid-1970s, European policy leaders became alarmed at the risk of a dislocation of Europe. Moreover, high inflation and rising unemployment following the 1973 oil crisis were a major concern. For some observers, a European monetary response was necessary (Figure 10.1.).

**Figure 10.1.** Young people demonstrate in support of a European currency in front of the European Commission headquarters (the Berlaymont) on 5 December 1977. Courtesy European Communities, 1977.



In late 1977, Roy Jenkins, the President of the European Commission, delivered a speech in Florence where he called for a European monetary union. Shortly after, in 1978, French President Valéry Giscard-d'Estaing and German Chancellor Helmut Schmidt pushed for negotiating a new system, which entered into force in 1979: the European Monetary System (EMS). The European Council, a new EEC institution created in 1974 in which the heads of state meet, had also been an important player in the construction of this new system (chapter 3). The EMS was in many aspects similar to the snake. However, it added three new elements: a divergence indicator, credit mechanisms, and a European Currency Unit (ECU), a currency basket, in which all participating EEC currencies were entered with different weightings. As it was the strongest currency, the deutschmark tended in practice to be at the centre of the system.

## **2. Economists versus monetarists: macroeconomic coordination and convergence**

A long-standing debate about monetary union in the EEC revolved around macroeconomic coordination and convergence, and in particular opposed 'monetarists' and 'economists'.

Monetarists, in this context, had nothing to do with Milton Friedman's monetarism, that is the control of money supply in the economy. In the EEC context, monetarists were those considering that monetary union would induce economic convergence. Economists, on the contrary, believed that economic convergence was a prerequisite for monetary union. Therefore, the economists' view was sometimes nicknamed the 'coronation' theory, as monetary union would be the final step of a lengthy process of economic convergence. Even though lines were not rigid in this matter, the French government tended to be monetarist, whereas the German and the Dutch governments tended to be economists. For monetarists, economic convergence was important but would never materialize unless a constraint, such as monetary union, would exert enough pressure on governments. For economists, a monetary union without sufficient economic convergence would be unstable. Compared to the slow-moving 'coronation' approach, the monetarists' approach has also been referred to as the 'Nike approach': 'Just do it' (Mourlon Druol 2012: 17). It is possible to trace these debates from the 1960s until today.

Like other areas of EMU, macroeconomic coordination is an integral part of EMU and has been considered so from at least the 1960s. Macroeconomic coordination primarily concerns the coordination of EEC/EU states' budgets, but also economic policy guidelines, for instance labour market reform. Macroeconomic coordination affects exchange rates fluctuations, which can themselves affect trade. However, it has always been a heated subject because it pertains to member states' sovereignty. The two first commissioners for economic and financial affairs, Marjolin (1958-1967) and Raymond Barre (1967-1973), two Frenchmen, stressed the need to better synchronize European economic policymaking. Their economic thinking was influenced by the French tradition of economic planning, which the German tradition of ordoliberalism opposed (Seidel 2016, Warlouzet 2018). In the 1960s, various committees were created to foster the coordination of



macroeconomic policies: a short-term economic policy committee in 1960, a budgetary policy committee and a medium-term economic policy committee in 1964. In 1974, these committees were merged into the Economic Policy Committee. These committees offered useful forums to exchange ideas and national practices, but the concrete results of this coordination were at best limited.

Finally, like other policy areas central to EMU, financial transfers in the EEC/EU have a long history (chapter 12). The EEC Treaty already foresaw the creation of a European Social Fund and a European Investment Bank. The European Coal and Steel Community also had redistributive schemes for workers and regions affected by the crisis of these sectors in the 1960s. Some observers also considered the common agricultural policy, established in 1962, as a form of 'social policy'. The European Social Fund, the first 'structural fund', aimed at improving social cohesion and focused on the retraining of workers in all sectors except agriculture. The European Investment Bank borrowed funds on financial markets and lent them to projects that supported the EEC's objectives. Thus, several EEC programmes long had a redistributive logic, implying transfers from richer to poorer areas. However, the amounts involved were minimal.

The question of financial transfers became more important in the 1970s, when the economic crisis hit EEC countries. On the insistence of the United Kingdom and Ireland joining the Community, and with the strong support of Italy, the European Regional Development Fund was created in 1975. During the EMS negotiations in 1978, there was also much debate over the extent to which richer member states could support the participation of weaker currency countries by financial transfers. The UK, Italy and Ireland, in particular, argued that their participation in the EMS would be difficult without such support. Even though these discussions did not lead to a notable political outcome, they were revealing of the relations between monetary integration and financial transfers. Three major reports addressed this issue in the second half of the 1970s: the Marjolin Report and the Tindemans Report in 1975, and the MacDougall Report in 1977. Belgian Prime Minister Leo Tindemans called for greater economic integration in support of monetary integration. Marjolin advocated a massive increase in the EEC budget. A last report by a group chaired by Donald

MacDougall, requested by the Commission, enquired further into the role of public finances in European integration. It also advocated an increase in the EEC budget to support a monetary union (Dyson, Quaglia 2010). The budget of the EEC was indeed very limited compared to federal states in a monetary union: it was about 0.7% of the EEC's GDP, whereas other federations had a federal budget of about 20-25% of their GDP. These discussions show that financial transfers in support of monetary integration were also discussed well before the creation of the euro.

### **3. The 1980s, Maastricht and the start of the euro**

The 1980s witnessed a new dynamism in the European integration process including a relaunch of plans for a future EMU. The 1985 White Paper of the Commission proposed about 300 directives aiming to complete the single European market by 1992 (chapter 3). Its focus was really on the EEC internal market, but some actors, in particular Jacques Delors, the President of the European Commission (1985-95), and the Italian economist Tommaso Padoa-Schioppa, a former Commission official who drafted an important report on this topic in 1988, considered that the establishment of an EMU was a necessary further step for completing the single market. Without an EMU, exchange rate variability could form a non-tariff barrier to intra-EEC trade.

An integrated financial sector was also conceived as a necessary condition for a well-functioning EMU. However, creating an integrated banking and financial market proved difficult. The Commission devised early plans for a common market in banking in the mid-1960s and slowly constructed this common market through so-called banking directives, particularly the first banking coordination directive of 1977 and, most importantly, the second banking directive of 1989 (Drach 2020). These directives were supposed to ensure banks' freedom to establish and provide services within the Community. The Council of Ministers adopted similar directives for the insurance and securities industry. In negotiating these directives, governments disagreed about what degree of openness was desirable towards non-EEC countries. While the UK fiercely opposed anything that

could resemble a 'fortress Europe', other countries, in particular France, wanted to impose reciprocity conditions for entering the EEC market in order to have leverage over non-EEC countries. Eventually, the directives adopted a liberal approach, with no strict reciprocity conditions. However, European banks stayed very rooted in their national markets. When involved in international activities, banks were more interested in global than in European affairs. Furthermore, national banking authorities were not ready to lose control over their banking systems. The Commission's single market project included many directives in the financial sector. In particular, a directive on full liberalization of capital movements in the EEC was enacted in 1988 (Drach 2021). European policymakers considered this directive as a necessary step before establishing an EMU. Other directives in securities, banking and insurance aimed at establishing a single financial market. However, the single financial market was never fully realized.

The functioning of the internal market could also be disturbed by the free movement of capital. The Italian economist Padoa-Schioppa put forward the idea of the 'inconsistent quartet', meaning that one could not have at the same time free trade, free capital movements, fixed or managed exchange rates, and monetary policy autonomy. In that perspective, the single market, therefore, necessitated a monetary union. In the meantime, EEC finance ministers and central bank governors were looking for ways to strengthen the EMS. One issue that regularly came up in analysing the functioning of the EMS was that of central bank intervention *within* the fluctuation margins. In 1987, the EEC central bank governors, meeting in Basel, issued a report on 8 September, and the EEC finance ministers endorsed it on 12 September, during a meeting in Nyborg, in Denmark. What became the 'Basel-Nyborg agreement' aimed at strengthening the EMS. It reinforced the surveillance of policy inconsistencies among EMS countries and introduced intra-marginal interventions, whose aim was to help prevent currencies from reaching their limit and to fight speculation.

In June 1988, the European Council asked Commission President Delors to chair a committee that would study how a monetary union could be achieved in the EEC. The 'Committee for the Study

of Economic and Monetary Union', better known as the Delors Committee, was primarily composed of central banks governors; this was a major difference from the Werner Committee, which included the presidents of the EEC Committees relevant to economic and monetary cooperation and integration, known for being favourable to EMU (Mourlon-Druol 2020). Delors considered that one of the reasons why the Werner plan had failed was that central bankers had not been involved at the time of its conception. Central bank governors were considered to be less favourable to the progress of EEC monetary integration, particularly the governor of the Bank of England, Robert Leigh-Pemberton, and the president of the Bundesbank, Karl-Otto Pöhl. The fact that they sat on the Committee in their personal capacity and not as representatives of their institution and that their work was confidential and based on mutual trust helped the discussion. The group also included a few other experts, such as the Belgian Alexandre Lamfalussy, the general manager of the Bank for International Settlements.

In April 1989, the group submitted a report proposing the creation of an EMU in three stages (cf. chapters in Dyson, Maes 2016). It was, to some extent, quite similar to the 1970 Werner report. However, it was deliberately vague regarding the timetable for stages two and three. Delors thought that a too rigid timetable had prevented the Werner plan from being implemented. A second difference was that the Delors report insisted less on the economic dimension of EMU than the Werner report. Indeed, the Werner report had also contained ambitious plans for the coordination of economic policy in the EEC. The first stage of the Delors report required the reinforcement of economic and monetary cooperation and the completion of the single market. That stage did not necessitate a new treaty, but such a treaty would be needed for the second stage, which focused on introducing a new European system of central banks. The third and last stage involved the irrevocable fixing of parities and the transfer of monetary authority to an EEC institution. The members of the Delors Committee unanimously endorsed the report. Most central bank governors did not expect that anything significant would come out of it, however. But it proved very influential

on the 1992 Maastricht Treaty, and is now seen as having been the first roadmap to the euro (Dyson, Featherstone 1999).

The EEC heads of government also endorsed the Delors report. Furthermore, the fall of the Berlin Wall in November 1989, and the prospect of German reunification, accelerated the process, as the French and German leaders were convinced that a reunified Germany needed to be integrated into a strong European framework. The programme of the Commission for the creation of a Single Market by 1992 was also triggering much enthusiasm in business circles (chapter 3). Even in the City of London, which was initially sceptical about the advantages of European integration, there was optimism. In July 1988, at a meeting of City actors chaired by the Bank of England on the subject of the creation of the single market by 1992, Jeremy Morse, head of Lloyds Bank and of the British Bankers' Association, declared that 'it was difficult not to be excited by the sense of movement' (Drach 2020). As the establishment of EMU necessitated a new treaty, and as a new treaty necessitated an intergovernmental conference (IGC), the Strasbourg European Council of December 1989 called for an IGC, despite the opposition of the UK.

The IGC started in December 1990 and led to the Maastricht Treaty, signed on 7 February 1992. The Maastricht Treaty largely incorporated the Delors Report of April 1989. Four criteria were established to join the euro: price stability, government finances, exchange rate stability and convergence of interest rates. The government finances criteria became the most famous one and required that deficits should not exceed three per cent of GDP and public debt 60 per cent of GDP. The Maastricht Treaty devised three stages, like the Delors Report had suggested, to establish EMU. Stage 1 was to run from 1 July 1990 to 31 December 1993, stage 2 from 1 January 1994 to December 1998, and stage 3 from January 1999. Economic convergence, central bank independence, and fiscal discipline were the central pillars of EMU.

The process towards EMU was disturbed by a severe monetary crisis. Just a few months after the Treaty of Maastricht was signed, several of the currencies composing the EMS went through heavy speculative attacks, which forced some of them to leave its Exchange Rate Mechanism. As the

agreement to move forward towards EMU had just been made, the crisis was a major threat to the whole project, but also an occasion for some countries, in particular France, to show their commitment to it. Furthermore, the crisis revealed the rising importance of global financial markets, as it appeared as a battle between states and markets. On 2 June 1992, the Danish voters rejected, by a slight majority, the Maastricht Treaty. That is usually considered as the start of the crisis, as it generated doubt about the future of EMU. The day after, the French President François Mitterrand declared that a referendum on the Maastricht Treaty would be held in France, too. If polls were initially giving a large majority to a 'yes', they quickly became much more uncertain, which spread doubt on the soundness of the EMU project among financial markets, and thereby, on the EMS. In addition, the economic consequences of German reunification impacted other EEC countries: in order to fight inflationary pressures, the Bundesbank was setting high interest rates, which threatened the Exchange Rate Mechanism of the EMS. Lastly, European economies were going through a recession at that time. In this context, private financial actors could bet that some currencies were overvalued and could be forced to leave the EMS and devalue if they exerted enough pressure triggering massive currency speculations.

These speculations first hit the British pound sterling and the Italian lira. When the pound had joined the EMS in 1990, many observers thought it was overvalued. In September 1992, several financial institutions massively sold their pounds in the hope to force the UK to devalue and then make a profit on the difference. In particular, the Quantum Fund of George Soros played a leading role in the pressure to devalue the sterling, selling £ one billion on 15 September 1992 alone, and eventually forcing the British currency to leave the EMS on the 16<sup>th</sup>, a day that became known as 'Black Wednesday'. On the 14<sup>th</sup>, the Italian government had already devalued by 7 per cent. On the 17<sup>th</sup>, both the Italian lira and the pound sterling left the EMS. Speculation then turned to the Spanish peseta and the Finnish markka, both forced to devalue too. On 20 September, the approval of the Maastricht Treaty by a referendum in France was much tighter than expected: speculation turned to the French franc, and on 22 September, the Bank of France used in a few hours its entire foreign

currency reserves to purchase francs and defend its currency. The cooperation with the German Bundesbank was critical, as it supported the purchase of francs by the Bank of France by unlimited deutschmark credits. The Banque de France and Bundesbank issued a joint statement on 23 September. Eventually, speculation receded. However, it boomed again in late November 1992, against the French franc, the Spanish peseta, and the Portuguese escudo. In February 1993, speculation hit the French franc again, in the context of upcoming legislative elections, as well as the Irish pound. After a final and exceptional speculation wave in July 1993 against all EMS currencies except the deutschmark, the EMS governors and finance ministers, meeting in the Monetary Committee of the EEC, decided to widen the EMS margins from 2.25 to fifteen per cent: the speculation ended once and for all. The cooperation between central banks had proved critical in this crisis resolution, but also the political pressure on the Bundesbank to help the French franc. The fact that France had not devalued the franc was interpreted as a commitment towards EMU.

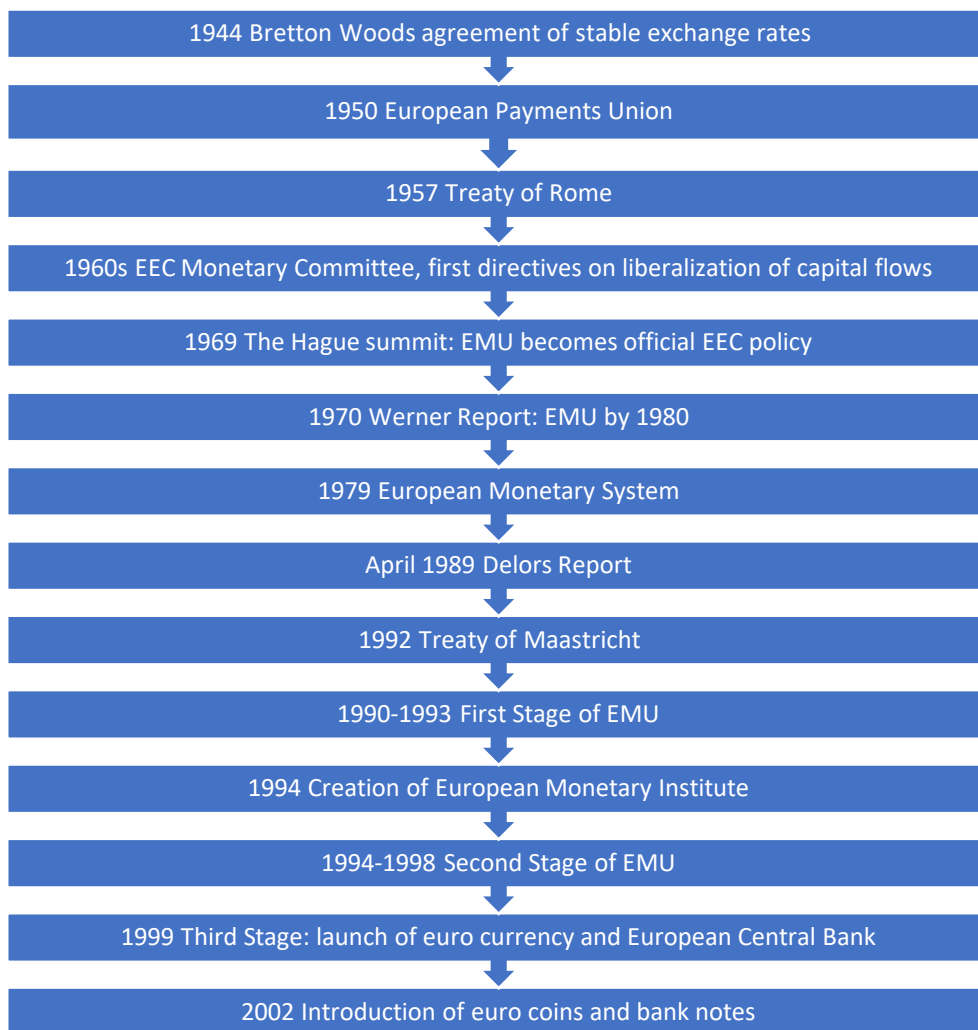
Two major possible weaknesses of EMU were already widely discussed by central bankers at the time of the Delors report, and have attracted much debate since then: the coordination of member states' budgets (often called 'fiscal discipline') and banking regulation and supervision. The first issue dominated the 1990s. Germany was a strong supporter of fiscal discipline and of a strict interpretation of the three per cent deficit rule of the Treaty of Maastricht when assessing which country qualified for the euro. However, while being above the Maastricht limits, some countries could not reasonably be excluded from EMU: Belgium had a debt of 130 per cent of GDP in 1997, but was host to many European institutions and was in a monetary union with Luxembourg, whose credit was excellent. Italy's debt was high (120 per cent of GDP), but lower than that of Belgium, so it could not be excluded if Belgium was accepted. In the mid-1990s, the German Finance Minister Theo Waigel proposed a Stability Pact that would implement the Maastricht rules on debt and deficit. Under French pressure to take economic growth into consideration, the Stability Pact became a Stability and Growth Pact (SGP). However, in 2003, both France and Germany infringed the SGP, and pushed for its suspension, arguing that there was a risk of recession. In 2005, the European Council

revised the SGP, softening the disciplinary procedure in case of infringement. The fact that the two biggest countries of the Eurozone had violated the SGP outraged several other member countries. The question of financial regulation and supervision, however, proved more urgent in the wake of the Global Financial Crisis.

In 1998, the European Commission and the European Monetary Institute, which had been created as part of stage two of EMU as a transitional institution before the European Central Bank (ECB) was established, submitted their convergence reports examining which country could join EMU. Eleven countries met the criteria: Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain. In 1999, parities between exchange rates were irrevocably fixed, and the euro came into force on an immaterial basis. Coins and banknotes were introduced in 2002. The eleven countries adopted the euro. Greece joined them in 2001, and others did so too from 2007 onwards (Figure 10.3). During its first years of existence, the euro worked reasonably well. However, things would turn much more difficult after the Global Financial Crisis hit.

**Figure 10.2.** Timeline of economic and monetary union





**Figure 10.3.** Enlargement of the Eurozone

<b>Year</b>	<b>Country</b>
<b>1999</b>	Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain
<b>2001</b>	Greece
<b>2007</b>	Slovenia
<b>2008</b>	Malta, Cyprus
<b>2009</b>	Slovakia
<b>2011</b>	Estonia
<b>2014</b>	Latvia

2015	Lithuania
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#### 4. The euro crisis

In 2007-8, the outbreak of the Global Financial Crisis devastated the financial systems and economies of many countries in the world. Although many American observers anticipated a US-China crisis The actual crisis had a profound North Atlantic character, and revealed the deep financial ties between the North American and the European financial systems (Tooze 2018). The US domestic consumer market had been in part funded by European credits. While the crisis weakened large European banks, European governments' debt also increased in the wake of stimulus packages enacted to fight the social and economic effects of the crisis.

In October 2009, the newly elected Greek government announced that the country's public deficit would be much higher than the figures notified to Brussels. In November, it announced a 12.7 per cent deficit, instead of the official 5.7 per cent. This declaration is often considered as the start of the eurozone crisis. One month later, rating agencies downgraded Greece's sovereign credit rating, and Greece and other European countries entered into a debt crisis threatening the whole euro architecture. Doubts about debt sustainability soon hit Portugal, Spain, Italy, and Ireland, and a series of bailout negotiations tore Europe apart. Beyond the sole Greek episode, the European debt crisis exposed the structural weaknesses of EMU. In particular, some observers stressed the lack of financial transfers (the so-called 'fiscal transfers') and of common supervisory and regulatory mechanisms in the Eurozone, while others underlined that the European Central Bank was excessively focused on monetary stability. In addition, the crisis revealed the profound economic divergence of Southern and Northern European countries. Lastly, the crisis was not only an economic one: it was also a deep political and social crisis, with European national media taking sides for or

against indebted countries. Between 2009 and 2012, the Greek GDP shrank by 25 per cent and unemployment rocketed.

The crisis also revealed to the general public the intertwining of financial, monetary and fiscal issues. During the years preceding the crisis, there had been a massive flow of capital from Northern to Southern Europe. Because there was a monetary union, borrowers from Southern Europe were able to borrow at lower interest rates than they would otherwise have been able to, which, according to some observers, incited them to become overindebted. With the Global Financial Crisis, the capital flows within Europe diminished, and the growth performances of Southern European countries looked much grimmer than before. That cast doubts on the ability of states to repay their debts. In addition, Northern European banks had lent to Southern European states, and in general European banks had lent to their own states: that created a bank-state 'doom-loop', whereby banks were exposed to states, and states depended on banks, in addition to being the banks' regulators and potential lenders of last resort. As the financial and sovereign crisis deepened in Europe, financial fragmentation increased: banks were retreating within their national markets to reduce their exposure to risky indebted states, sometimes under the guidance of banking supervisors who urged them to withdraw from these areas. If financial flows had widely circulated within the Eurozone before the crisis, banking structures had, in fact, remained profoundly national, at least in Western Europe. The withdrawal of banks from Southern European markets aggravated the crisis and reduced the access of Southern European countries to funding. In October 2010, the agreement of the French President Nicolas Sarkozy and the German Chancellor Angela Merkel to involve private lenders in the crisis resolution increased their anxiety, as financial actors now considered that a risk of default was a plausible possibility, whereas they previously considered that was impossible (James 2016).

The crisis triggered considerable debate about the architecture of the euro area and the role of the ECB. While the ECB could not act as a lender of last resort, contrary to other central banks in the world, the ECB President Jean-Claude Trichet did launch a broad series of operations from 2010

onwards. The Securities Market Programme (SMP), started in 2010, enabled it to buy sovereign bonds on secondary markets. The Long-Term Refinancing Operations, started in 2011, was meant to support bank lending and bank liquidity. The Outright Monetary Transactions (OMT), launched in 2012, was similar to the Securities Market Programme, which aimed to buy sovereign bonds on secondary markets, but this time had no ex-ante quantitative limits. Lastly, in 2015, the ECB launched the Public Sector Purchase Programme (PSPP), officially marking its adoption of quantitative easing through a regular purchase of sovereign bonds and securities to support economic growth. This programme ended progressively in 2018. The use of rhetoric and persuasion of financial markets of the credibility of the euro also played a major role in the handling of the crisis: in 2012, Mario Draghi, the new president of the ECB who had replaced Trichet in late 2011 (see picture 3), pronounced his famous phrase at the Global Investment Conference: 'the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough.' The speech had an important effect in reassuring markets. Eventually, the euro survived the crisis, and Greece stayed in the Eurozone, warding off fears of a 'Grexit' that had spread at the peak of the crisis.

**Figure 10.4.** Handover of the Presidency of the ECB, represented by a bell, between Jean-Claude Trichet, on the left, and Mario Draghi (2011). Courtesy of European Union, 2011.



The reaction to the euro crisis came together with a new, or reinforced, political economy for the Eurozone. That included austerity measures, the enactment of a series of actions aiming at strengthening the Single Market (Single Market Act I and Single Market II, in 2011 and 2012,

respectively), a new financial assistance framework for the Eurozone, and a new framework for the Eurozone's economic governance. Several observers consider that austerity measures aggravated the crisis rather than helped solve it (Sandbu 2015). Public debt being a central issue of the Euro crisis, reducing it through limiting public spending seemed the easiest way out. However, it also contributed to reducing people's income and consumption, and to increasing poverty. Critics also condemned the excessive austerity measures imposed on Greece, their limited impact on Greece's indebtedness, or the fact the ECBs quantitative easing measures tended to favour the wealthiest part of population who held financial assets. Austerity measures were compensated by the Growth Pact of 2012, a stimulus package aiming to stimulate the EU economic growth, but which was mainly based on already existing mechanisms and funds. The new financial assistance framework was created in the wake of the Greek sovereign debt crisis: in June 2010, the Eurozone member states created the European Financial Stability Facility, a temporary rescue mechanism issuing bonds on the capital markets and lending them to countries facing difficulties. In 2012, the European Stability Mechanism (ESM) was introduced as a permanent mechanism. Lastly, the Eurozone's economic governance was reformed in the wake of the euro crisis. The Stability and Growth Pact, introduced in 1997 and reformed in 2005, was further reformed with two series of regulations in 2010 and 2011: the 'Six Pack', comprising six measures improving macroeconomic surveillance, and the 'Two Pack', comprising two regulations on the frequency of the monitoring. In addition, the European Semester was introduced in 2010. It aimed at helping member states coordinate their economic and social policies through a dialogue between the Commission and member states during the elaboration of national budgets. In 2012, the Treaty on Stability, Coordination, and Governance was signed: it aimed at limiting deficits, improving macroeconomic coordination and strengthening correction mechanisms.

One of the most important political outcomes of the euro crisis for the Eurozone was the development of the European banking union, from 2012 on. The rationale of banking union was to move banking regulation and supervision from the national to the supranational level, giving in

particular supervisory powers to the European Central Bank. Banking union is composed of two pillars, the Single Supervisory Mechanism and the Single Resolution Mechanism, and is based on the Single Rulebook. The Single Supervisory Mechanism (SSM) means that it is now the ECB, and not national supervisory organizations, which is in charge of supervising large banks in the Eurozone, that is, the daily control of their activities to prevent excessive risk-taking. The ECB took on this role in November 2014. The Single Resolution Mechanism (SRM) is a scheme designed to handle the failure of a bank (with possible multiple entities all over the Eurozone and beyond) in the Eurozone through a common resolution authority, the Single Resolution Board. The SSM and SRM are based on the regulations established on the Single Rulebook, which set the rules, such as capital requirements, governing the financial sector in the entire European Union, and not on the Eurozone only. A proposal for setting up a European scheme for Deposit Insurance, which would form a third pillar to the European Banking union, is still under discussion, but faces considerable political obstacles. The Banking Union is therefore not considered as complete.

The measures enacted to establish banking union in the Eurozone were not new ideas: coordinating banking regulation and improving banking supervision has long been discussed in the EEC. From the mid-1960s on, much work has been done in these two areas. However, the exercise proved long and arduous: differences in regulatory and supervisory systems were too large for them to be completely harmonized. For a long time, a middle way was preferred: that of cooperation between national supervisory and regulatory systems. Eventually, the Euro crisis provided the political impetus for a major change in the area. Though apparently mostly technical, the Banking Union was a major political and institutional change, as it moved banking supervision to the supranational level. However, most observers consider that EMU is not complete, and the political economy of the eurozone is still a hotly debated topic.

## **Conclusion**

The history of EMU shows that some of the weaknesses of the euro's architecture that became obvious at the time of the euro crisis had already been widely discussed before. The other take-away point is that EMU cannot be understood in isolation but is and has always been closely linked to national and international economic policies, trends and events. Furthermore, this chapter underlines the importance of the *E* in EMU: the story of EMU is not only about monetary cooperation and integration but also about the *economic* conditions for making EMU work. Macroeconomic coordination, financial regulation and supervision and financial transfers have long been discussed in the EEC/EU. EMU has also been considered as a major step for the completion of the single market. In addition, even though the need for a reinforced monetary integration in the EEC emerged from the global monetary upheavals of the late 1960s/early 1970s, monetary cooperation and integration were already discussed before. Therefore, the history of EMU is economic, monetary, and political at the same time.

EMU entails several advantages and disadvantages, which partly explains its complex historical path (Verdun 2002). On the one hand, it eliminates exchange-rate risk, strengthens the single market, facilitates cross-border financial transactions, makes travelling easier for consumers, and reinforces the EU as an international actor. On the other hand, it entails a loss of national sovereignty, removes exchange rate flexibility that could absorb asymmetric shocks, exacerbates the need for greater cohesion and convergence, and raises democratic concerns, in particular concerning the control of the ECB.

Whether it was the incomplete architecture of EMU or the economic policies taken by member states that caused the severity of the euro crisis remains the subject of much debate. However, the entanglement of economic and monetary affairs with critical political and social stakes is undeniable. Despite its technicalities, EMU affairs have a long and multi-faceted history, with no simple path leading to ever closer integration, but with crises, disputes, and reversals. The fact that the EMU survived the euro crisis not only showed its centrality to the European economy and the European project, but also the many issues still to be resolved for its completion. The fact that the



EMU project is closely linked to the EU project as a whole certainly plays a role in Eurozone member states' commitment to it.

#### Key questions

1. Was the creation of a monetary union the logical outcome of the creation of a unified market?
2. Why and how was the euro created?
3. What are the advantages and disadvantages of forming an Economic and Monetary Union in the European Economic Community?
4. What were the weaknesses of EMU that observers stressed in 1992? And did observers during the Euro crisis flag up similar issues?
5. What does the "E" in EMU refer to and why does it matter?

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