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Iain Begg
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1 Introduction

The creation of the euro was, by any reasonable standard, a bold extension of the European integration project. From the ruins of World War II, Europe's leaders had moved by stages from the limited industrial cooperation of the European Coal and Steel Community, established in 1951, to the single European market, with its four freedoms of movement of goods, services, labour and capital. By the early 1990s, this market integration was – though still subject to many sources of friction and tension – well on its way to completion.

Plans for monetary integration in Europe had been under consideration from the 1960s, but only came to fruition right at the end of the twentieth century (De Grauwe, 2022; Pomfret, 2021). This long gestation can be explained in a number of ways. Proposals for a monetary union elaborated in the 1970s fell foul of a succession of economic crises after the so-called *trentes glorieuses*, the long period of post-war growth up to 1973. Disagreements about how to construct a monetary union were legion and compromises hard to find (McNamara, 1998; Dyson and Featherstone, 1999). More fundamentally, two widely recognised defining attributes of a state have long been security and the currency; forgoing the latter, especially for the likes of Germany, where a strong and stable Deutsche Mark (DM) had so much symbolic value, was always going to be politically challenging.

Economic and monetary union (EMU) is a wide-ranging project because of the adjective 'economic'. A monetary union on its own would mean integration only of the currency, whereas including economic in the union implies the integration of a variety of other policies. Today, EMU in Europe has to be understood in this broader sense as many of the difficulties and challenges it faces are beyond the scope of monetary policy alone.

Initial attempts at monetary cooperation in the early 1970s – sometimes referred to as the 'snake-in-the-tunnel', limiting exchange rate fluctuations among European Union (EU) members, while providing flexibility for movements vis-à-vis third countries – rapidly fell apart when oil prices soared after the Yom Kippur war. The more comprehensive European Monetary System, introduced in 1979, did succeed in stabilising exchange rates, but had a variety of in-built tensions and was widely seen as a step towards monetary union, not an end in itself. The Maastricht Treaty agreed in 1990 then paved the way for the creation of the single currency.

1.1 The Euro's Ups and Downs

After its launch, the euro seemed to prosper. Monetary policy, though not without its critics and occasional challenges from governments who each felt that it should bend more to their own country's needs, functioned as intended and, as the

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European Central Bank (ECB) has often stated, price stability was achieved. Notes and coins were introduced on schedule and with only mild tensions: who now remembers the derogatory term 'teuro' – a play on the German word for 'expensive' – used in Germany to capture the slight rounding-up of prices by retailers when the DM was replaced? The euro rapidly accounted for some 20 per cent of international reserves and financial markets accepted the new kid on the block. More broadly, the governance of EMU, though again not without its critics and clashes (especially over public finances), generally functioned as intended.

When the global financial crisis struck in 2007, the euro (and the Eurozone) initially seemed less affected than other major currencies, although it was then hit by what is now known as the sovereign debt crisis. The consensus now is that, in its first decade, the euro had flattered to deceive, notwithstanding the many celebrations as it reached its tenth birthday. A decade later, the storyline was very different. As others recovered from the global financial crisis, shortcomings in the design of the euro, compounded by policy errors and an inability to agree on solutions, were cruelly exposed. Many pundits were ready to write EMU's obituary when the sovereign debt crisis was at its worst in the early 2010s. These failings prompted a far-reaching and (at least by EU standards) almost frenetic effort to re-engineer the governance framework. Despite some hiccoughs, the euro survived, and few would now question its durability.

These efforts have, variously, been described as 'completing' EMU or establishing a 'genuine' EMU. The title of this Element conflates these two phrases. In 2012, blueprints emanating from the EU institutions listed a series of prerequisites for arriving at a 'deep and genuine EMU'. This was followed three years later by a somewhat less ambitious roadmap for 'completing economic and monetary union'. Both gave rise to policy initiatives and institutional developments intended to bolster the resilience and effectiveness of the governance of the euro. However, progress was slow and often contested, even before the pandemic struck, and the conjunction of rising energy prices and the war in Ukraine further postponed the enactment of many initiatives.

1.2 About This Element

This Element looks at the evolution of the euro, especially over the last decade, asking if enough has been done to render it more sustainable and resilient. These questions have acquired new salience as a result of geopolitical developments. The pandemic, the surge in inflation and the ramifications of the Russian invasion of Ukraine have called into question how the EU can work collectively, obliging Europe's leaders to review their approach to what might be called

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domestic-first economic policies and political preferences. It may provide incentives for more rapid and decisive innovation in the governance of EMU. On the other hand, the sheer magnitude of the current challenges may put on hold many of the reforms winding their way through the system and it is unclear how the euro will be affected.

To gauge opinion on what is likely to happen next in the evolution of the euro, a survey of experts on the euro was conducted in the second semester of 2020, specifically for this Element.* The approach was to pose a mix of structured and open questions focussed on some of the main areas of contestation about what is needed for the euro to prosper. The survey is not representative, but rather was a means of tapping into the expert knowledge of the range of people approached. It elicited 111 responses from nationals of 25 countries (including 3 outside Europe), achieving a response rate of around 80 per cent of those approached, with only 3 explicit refusals to participate. The biggest proportion of the respondents is academics, with the balance made up of practitioners, journalists, politicians and researchers in think tanks.

The completion rate of questions was very high, in some instances with explanatory comments substituting for tick-box answers. Where the respondents have given explicit permission to do so, certain comments are quoted verbatim and attributed. In other cases, to protect the identity of the respondent, quotes are presented anonymously.

Section 2 looks back at the debates and doubts about the wisdom of creating the single currency and examines the various views on why problems arose, then Section 3 ponders the meaning of a complete EMU. An overview of the performance of EMU is presented in Section 4, focussing on how and why problems arose. Section 5 sets out the main reforms in response to these problems, and how they sought to establish a 'genuine' EMU. In Section 6 the survey findings on how to ensure the long-term success of a complete and genuine EMU are summarised. Section 7 then looks at what remains to be done and considers the implications of recent geopolitical developments, and Section 8 concludes.

2 Was the EMU Project Wise?

Euro-scepticism is a phrase now associated with Brexit and insurgent populist parties opposed to European integration. Thirty years ago, a rather different scepticism was about whether creating the euro would be economically and – maybe less prominently – politically wise. Many in the economics profession, especially in the United States, had strong reservations about EMU's prospects, a stance summed up

* The author is immensely grateful to the respondents for taking the time to complete the survey and for the care taken in answering the questions.

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in the title of an article by Jonung and Drea (2010): 'The euro: It can't happen. It's a bad idea. It won't last. US economists on the EMU, 1989–2002'.

Their survey covered 130 academic papers by economists based in the United States and 40 by authors working within the Federal Reserve System. The latter were found to be more concerned about the practicalities of assessing eligibility for acceding to the euro, but also the implications for the dollar. But they, too, were prone to scepticism, as demonstrated by the title of an article by Adam Zaretsky (1998) of the Federal Reserve Bank of Saint Louis: 'Yes, this EMU will fly, but will it stay aloft?'.

Academic economists, by contrast, 'focused on weaknesses and problems in the monetary integration process, usually in long papers involving models and econometric tests' (Jonung and Drea, 2010, p. 9). The reasoning was strongly influenced by the theory of the optimum currency area (OCA) and the analytic conclusion that, because the putative new currency area was far from being one, it would struggle. In a cost–benefit framework, the more distant a currency union is from optimality the greater will be the net costs. Martin Feldstein is said to have predicted that it would lead to war, although what he actually wrote in *Foreign Affairs* was that 'it will change the political character of Europe in ways that could lead to conflicts in Europe and confrontations with the United States'.[1]

James Tobin (2001, p. 31), writing shortly before the introduction of euro notes and coins, yet more than two years beyond the delegation of monetary policy to the ECB (at the start of 1999), refers to the launch of the single currency as 'the euro experiment' (a phrase echoed by others, such as Schelkle, 2018 and Wallace, 2016, implying an easily reversible trial) and, contrasting it with the roots of the dollar, observes that the Maastricht Treaty is not the US Constitution. He goes on to issue a stark warning: 'without far-ranging changes to European institutions, it is hard to see how the euro can succeed'. Tobin compares some key attributes of the dollar and the architecture of the (then infant) euro to underpin his warning, citing:

- the narrower focus of Eurozone monetary policy on price stability, in contrast to the Fed's dual mandate, which enables it to act to curb unemployment;
- the lack of fiscal capacity at the Eurozone level and, as a consequence, of automatic fiscal stabilisers able to cope with cyclical fluctuations;
- the limited scope for market mechanisms to effect economic adjustment because of various structural rigidities, including sticky wages, a low propensity to migrate and a variety of institutional barriers to cross-border flows of labour and capital.

[1] Martin Feldstein, 'EMU and international conflict', *Foreign Affairs* (November/December 1997), www.foreignaffairs.com/articles/europe/1997-11-01/emu-and-international-conflict.

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In concluding, Tobin writes: ‘it may be that the challenge of adapting to an irreversible currency union will bring the farsighted building of institutions needed to make the experiment successful. For Europeans’ sake, let’s hope so’ (Tobin, 2001, p. 33). His words suggest the key questions that this Element tries to answer. How and why does the euro fall short of being a ‘genuine’ currency or ‘complete’ form of EMU? What needs to be done to make EMU substantially more complete and why is there entrenched resistance to what might seem to be the obvious and necessary steps towards it?

Kenen (1992) offers an excellent overview of both what was agreed at Maastricht and the potential risks. Presciently, he noted two likely concerns around fiscal policy: the policy mix problem arising from national autonomy in setting the fiscal stance; and the solvency problems if one member’s profligacy has effects on others. Kenen (1992, p. 107) concludes his analysis by observing that although he approved of the idea and the blueprint for the euro, ‘the blueprint is imperfect and incomplete’. He further notes the many difficulties ‘answered sensibly, though compromise sometimes triumphed over clarity’.

Kenen (1992, p. 107) also draws analogies with the United States, reminding readers that ‘the Federal Reserve System was likewise a compromise, balancing the needs of an emerging continental economy with regional interests and concerns, and it took many years for the new institutions to solve the problems generated by the need for compromise’. He ends optimistically, again alluding to US experience, but with this warning: ‘the speed of adaptation in Europe will depend critically on the further development of the Community as a political entity’. As Barry Eichengreen and Charles Wyplosz observe in an obituary for Kenen, who died in 2012 at a time when the problems of the euro were at their worst, ‘more than any other economist, Peter understood that monetary union was a legal as well as an economic construct’.[2] In addition, he drew attention to its political nature and the still unresolved matter of how to complete it politically.

As noted, monetary integration draws on the notion of the OCA, an approach that, as its name implies, attempts to establish when it makes sense to form a currency union as opposed to sticking with separate currencies. Various criteria have been put forward to ascertain optimality in an extensive literature since Mundell (1961) introduced the concept. In practice, three questions arise: given the many criteria, does the balance of benefits and costs justify joining the currency union; are its design or institutions suited, or capable of being amended, to achieve something closer to optimality; and can the structures and political economy of the participating countries adapt to be a better fit with the partners in the union?

[2] Barry Eichengreen and Charles Wyplosz, ‘Kenen on the euro’, *Voxeu Column* (21 December 2012), https://voxeu.org/article/kenen-euro.

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Many economists, especially in the United States, stressed that the basic tenets of OCA theory had been neglected in the way the euro was introduced (Krugman, 2012; Jonung and Drea, 2010; see also Papaconstantinou, 2019), while the interplay between politics and economics in launching the euro, too, is part of the story (Snaith, 2014). However, a counter-argument, well articulated by Barry Eichengreen (2014), is that OCA theory itself – much of which was set out in the 1960s – is now very dated and has not kept pace with the evolution of international finance. Others have also queried whether the conventional OCA framework is helpful for understanding the euro crisis or how best to deal with it. Certainly, the euro cannot just be seen as a currency switch because it entails so many other adjustments to economic policymaking.

Despite the many doomsayers and sceptics, the euro, somehow, came into being. To the surprise of no one who has followed European matters, it was a compromise (Pisani-Ferry, 2014), not least in lacking features normally associated with a currency area. Many mainstream economists remained sceptical about its prospects and critical of its design, and when problems arose, some were quick to predict its demise (Stiglitz, 2016). But it has, so far, weathered the worst of the storms to hit it.

3 Defining a Complete and Genuine Economic and Monetary Union

Against this backdrop of an EMU widely adjudged to be suboptimal, it ought to be straightforward to define a viable EMU and to give substance to the terms ‘genuine’ or ‘complete’ in relation to EMU. There are several distinct, though connected, ways in which the completeness of EMU can be assessed. A document commonly known as the *Four Presidents’ Report* (European Council, 2012a) set out ‘a vision for the future of the Economic and Monetary Union’, proposing four building blocks for a more robust framework for the governance of EMU in the pursuit of a ‘genuine’ EMU:

- an integrated financial framework to ensure a financially stable system;
- an integrated budgetary framework with the dual aim of assuring fiscal discipline and developing new common fiscal policy instruments;
- an integrated economic policy framework able to promote growth, employment and competitiveness in a manner consistent with the smooth functioning of EMU;
- enhancement of democratic legitimation and channels of accountability, justified particularly by the loss of national autonomy in budgetary and other economic matters as a direct consequence of greater top-down constraints on economic decision-making.

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The first building block can be interpreted as *banking union*, the second as *fiscal union* and the last as at least a form of *political union*, while the third building block can be viewed as an elaboration of mechanisms to coordinate national economies more effectively and more comprehensively. Proposals for developing each of these building blocks were subsequently presented in a 'blueprint' by the European Commission (2012) and taken further at the end of 2012 by the European Council (2012b). Both of these documents included proposals on sequencing the introduction of the new measures, although it is noteworthy that they are by no means identical in what they propose.

Jerry Cohen (1994) suggests a basis for a definition in more political terms: there needs to be a sufficiently powerful state that is 'willing and able to use its influence to keep a currency union functioning effectively' and 'a broader constellation of related ties and commitments sufficient to make the loss of monetary autonomy, whatever the magnitude of prospective adjustment costs, seem basically acceptable to each partner'. Suggestions for how to construct an EMU reflecting Cohen's principles are put forward in the Commission blueprint (European Commission, 2012, p. 11):

- 'all major economic and fiscal policy choices of its Member States should be subject to deeper coordination, endorsement and surveillance at the European level';
- 'an autonomous and sufficient fiscal capacity that allows the policy choices resulting from the coordination process [should] be effectively supported'; while
- a 'commensurate share of decisions with regard to revenue, expenditure and debt issuance should be subject to joint decision-making and implementation at the level of EMU'.

These are ambitious requirements, given the reluctance of Member States to cede key economic powers to the supranational level. An underlying difficulty is the perceived democratic deficit of the EU institutions and the lack of consensus on how to redress it (Schmidt, 2020). No economic policy is devoid of distributive effects, though some are generally accepted to be more susceptible to them than others. Competition policy, for which the EU level has a prominent role, tends to be regarded as less politically sensitive, while monetary policy is in the middle of the spectrum. However, fiscal policy is often considered to be at the heart of the 'contract' between citizens and the state, and to need more visible democratic legitimation.

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3.1 Membership

A very obvious sense in which EMU is incomplete is in having only nineteen members out of the twenty-seven in the EU. There is little need to dwell on why this has arisen. On the one hand, would-be members had to pass qualifying tests – the well-known convergence criteria – which, although interpreted rather flexibly, have slowed accession in some cases. On the other hand, the Maastricht Treaty provisions for an opt-out allowed the UK and Denmark to remain outside, while the other non-participating countries are formally in derogation of their obligation to become members. Sweden, following rejection of monetary union in its (non-binding) 2003 referendum established a de facto political veto, despite not having an opt-out.

Shortly after acceding to the EU in 2004, several of the then new members, such as Poland, seemed to be keen, and on track, to join the euro, but chose not to rush until the real economy shock of membership had been accommodated. Yet their enthusiasm faded as they realised the ramifications of the financial and sovereign debt crises. Even so, both Slovenia (2007) and Slovakia (2009) successfully acceded to the euro before the sovereign debt crisis struck, although for the latter the obligation to contribute to the Greek bailout caused political turmoil.

In contrast to the currency boards operated by the three Baltic Member States, Poland, the Czech Republic and Hungary had adopted inflation-targeting monetary regimes. Like Sweden, this meant that they could not enter the exchange rate mechanism (ERM II) – set up as a form of 'waiting-room' for euro adoption – because this would have entailed switching from inflation targeting to exchange rate targeting. For the Baltic states, having sustained a fixed exchange rate since 1992 – initially vis-à-vis the German mark and subsequently against the euro – the transition was more straightforward. Successively, Estonia (2011), Latvia (2014) and Lithuania (2015) joined.

Since then, euro area enlargement has stalled. However, the dynamics could change sooner rather than later. In July 2020, Bulgaria and Croatia joined Denmark as members of ERM II, and Croatia is now on track to join in 2023. Bulgaria wants to follow, keen to escape what some have called the 'purgatory' of being in a fixed exchange rate system with few of the benefits of full membership. Romania may be next in line. Marek Belka, formerly President of the National Bank of Poland, suggested in 2020, in his response to the survey, that Bulgaria and Croatia 'are no longer a matter of speculation', a proposition echoed by many other respondents. Belka also says that 'if inflation spikes in Poland, it may reconsider its position' and believes that the Czech Republic 'will follow suit'.

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3.2 Common Policies

Being complete requires a policy framework that is able to act in the collective interest and, where necessary, to reconcile competing national interests, demands or preferences. In EMU, this has proved easier in some respects than others. Monetary policy had clear collective objectives and an explicit mandate, whereas fiscal policy and wider economic coordination were more diffuse.

The fundamental challenge facing EMU has been neatly explained by three senior European Commission Directorate-General for Economic and Financial Affairs (DG Ecfin) officials as an 'unsustainable equilibrium' made up of incomplete financial union, inadequate adjustment mechanisms and the lack of a central fiscal stabilisation function (Buti et al., 2018). Prior to the pandemic, it was an equilibrium in the sense that the existential threats to the euro had abated and there have been improvements in most of the relevant macroeconomic indicators. However, there is little doubt that the fiscal framework remains unsatisfactory and could face renewed turbulence in the aftermath of the pandemic and in light of events in Ukraine, in spite of the extensive reforms already enacted.

3.2.1 Monetary Policy

The aims of monetary policy are set out in the Treaty, emphasising a primary goal of assuring price stability. The institutional structure was also clearly specified, with the ECB at the apex of the European System of Central Banks (ESCB), in which the national central banks retain various responsibilities. However, monetary policy is unambiguously delegated to the ECB, with decisions taken by its Governing Council.

The ECB's 'two-pillar' approach to monetary policy was strongly influenced by Otmar Issing, the German member of its Executive Board. The first pillar was to monitor the growth of the money supply – a long-standing element of German monetary policy. The second pillar is more relevant to the short term and consists of leading indicators and measures of inflation expectations. In the words of Issing et al. (2001, p. 90), 'the range of relevant indicators, and their relative importance, change over time. Consequently, there is no permanently valid way to organise the assessment in a logically consistent manner.' In 2003, the first and second pillars were reversed, suggesting that the monetary pillar was being downgraded in importance, although Issing et al. (2001, p. 107) had explained that the separation between first and second pillar should be seen mainly as an 'organisational framework to structure the available information, both internally and for the benefit of the public'.

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