Ten years EMU: an assessment of ten critical claims

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Abstract: This paper seeks to review a selection of ten salient critical claims about Economic and Monetary Union (EMU) that were heard in the 1990s in either the Political Science literature or the Economics literature or both. In this paper, the author focuses on five salient Political Science claims and five Economics claims prominent at the time that pointed to problems with EMU that could undermine its viability. As we will see, based on an assessment of the first ten years of EMU, almost none of these claims – to date – turned out to be a problem.

Keywords: Economic and Monetary Union; euro; European Central Bank; fiscal policy; monetary policy; optimal currency area; political union; stability and growth pact; supranational economic government; welfare state retrenchment.

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1 Introduction

When Heads of State or Government of the 12 member states signed the Maastricht Treaty in 1992 and thereby launched the objective to create an Economic and Monetary Union (EMU) before the end of the decade, not everyone was equally enthusiastic about the plan. In fact, during the course of the 1990s, a host of analyses came out that warned against the possible negative effects of EMU once it was created. The European Union (EU) machinery, of course, had produced ample research that suggested that EMU would benefit the EU, such as the "One Market, One Money Report" (Commission of the European Communities, 1990), but that did not silence the critics.

This paper seeks to review a selection of ten salient critical claims about EMU that were heard in the 1990s in either the Political Science literature or the Economics literature or both. In this paper, the author focuses on five salient Political Science claims and five Economics claims that were prominent at the time. As we will see, based on an assessment of the first ten years of EMU, almost none of these claims – to date – turned out to be a problem.

The paper is structured as follows. The next section offers five selected Political Science claims with warnings about EMU. This section offers the context and reviews the literature from which the claims are derived. Section 3 provides a similar review of five Economics claims. In Section 4, the author discusses each of these claims in turn and offers an evaluation of the experience over the past ten years regarding each of the claims. Finally, Section 5 offers some crystal ball gazing. On the basis of the assessment of the first ten years, and reflecting on the 2007–2008 financial crisis and the subsequent economic recession, she speculates as to whether the risks associated with any of the ten claims might still materialise in the years to come.

2 The creation of EMU in the EU: political scientists' warnings

Although there has been ample literature explaining what EMU is, how it came about, and what is special about its particular institutional design, for the purpose of introducing the issues, let us first provide a brief overview of these matters.

The initiative to create an EMU in the European Community (EC) dates back to the 1960s and 1970s (Rosenthal, 1975; Tsoukalis, 1977). On the basis of the so-called 'Werner Report' (1970) in 1971 the Heads of State or Government of the then six EC member states committed to creating EMU by 1980. The plan failed owing to a combination of internal and external circumstances (Kruse, 1980). Eventually, in the late 1980s, following the main principles of the earlier Werner Report, a revised plan to create an EMU in three stages was reintroduced (Verdun, 2000). The so-called 'Delors Report' (1989) set out what EMU would be and the Maastricht Treaty incorporated most of the points of the Delors Report (Verdun, 1999).

EMU was created to build on a number of developments in European integration: the European Monetary System (EMS) (which contained an exchange rate mechanism that aimed at maintaining fixed but adjustable exchange rates that had been fairly successful especially in the latter half of the 1980s), the liberalisation of capital (1 July, 1990), success in European integration in a variety of areas of policy making, such as market integration.

Let us now turn to five main themes that have been taken from the Political Science literature in which critical noises were heard about EMU. They are

1. EMU would only go ahead and continue if it was in the interest of the large member states
2. the lack of economic government and political union
3. the democratic deficit of EMU

4 the lack of a common identity

5 EMU would cause welfare state retrenchment.

Let us turn to each of these five themes.

2.1 EMU and the importance of large member states

The literature on EMU focused considerable attention on its origins (for a review see Sadeh and Verdun, 2009). Moravcsik (1998) spelt out in much detail how the acceptance of EMU was in the interest of the large member states. The analysis offered is that it served the interests of large member states and thus it went ahead. A competing analysis by Dyson and Featherstone (1999) also examined the role of large member states but in their study the analysis hinges much more on the role of learning, ideas and policy entrepreneurship by the Commission and the Commission President, Jacques Delors (see also McNamara (1998) who also stresses the role of ideas). These were the years in which most scholars focusing on the origins of EMU concentrated on the large countries (see also Sandholtz, 1993; Verdun, 2000). Especially, the analysis by Moravcsik (1998) and to a lesser extent the article by Sandholtz and the book by Dyson and Featherstone (1999) supported the following claim:

> *Claim 1: EMU was created and will only survive if it remains in the interest of the large member states.*

2.2 Does EMU need a supranational economic government?

When EMU was designed, it followed an incremental path of European integration that had been followed for decades on which the fundaments of the EMU edifice were built. As a result, it firmed up the concrete basis that had been built throughout the 1980s through the EMS, the single market project and incremental integration in various areas of policy making. However, it did not introduce a fully fledged federal-like system. In the 1970s, various studies had examined the need for fiscal federalism in the EU (MacDougall Report, 1977). In other words, by the late 1980s and early 1990s although transfer of sovereignty over monetary policy was envisaged to occur with EMU, a similar transfer of fiscal policy (taxing and spending) to a supranational authority *was not* foreseen. Thus, the creation of a European System of Central Banks (ESCB) and a European Central Bank (ECB), modelled after the successful German central bank, the *Bundesbank*, was incorporated in the plan to create EMU in three stages. Yet, it did not envisage simultaneously the creation of a federal-like economic authority. This design of EMU, therefore, was 'asymmetrical' (Verdun, 1996, 2000; see also Hodson and Maher, 2002). On the one hand, monetary policy was to be transferred to a central, supranational body, whereas, on the other hand, no supranational economic authority was to be introduced to have the same mandate and powers as the ECB. Instead, the coordination of monetary and fiscal policies was to take place through informal and formal voluntary cooperation in the area of economic policy making.

From this analysis of the asymmetrical EMU came a series of criticisms by some Political Science scholars (and to some extent economists) on EMU. French politicians put forward the most poignant appeal for the creation of an economic government (see Howarth, 2007; Verdun, 2003), and more recently, a similar desire for institutional reform was reiterated by Padoa-Schioppa (2004). Very recently, a few scholars have once again reflected on this theme and offered reflective insights on this question (see inter alia Hodson, 2009). We can capture that criticism in the following simple claim:

> *Claim 2: EMU needs an Economic Government (or Political Union) or it will become unstable.*

2.3 A democratic deficit of EMU?

One side effect of this institutional design was that some felt that with the creation of the ECB at the supranational level and no transfer of sovereignty regarding economic policy (i.e. the lack of an economic government) economic policy might fall victim to a lack of speedy and effective coordination. Furthermore, not only was a transfer of policy authority on economic matters not part of the design, the existing political structures at the EU level also did not quite resemble those usually found in federal states. In other words, the institution responsible for coordination of economic and fiscal policies, 'ECOFIN' (the Council of Ministers of Economic and Financial Affairs), is not responsible to the European Parliament. Instead, individual ministers are responsible to their national parliaments. This political structure, which is quite different from that of existing democratic federal states, led to concerns being voiced about EMU lacking democratic accountability and legitimacy.

From this analysis of the democratic deficit of EMU came a criticism shared by some political scientists (Majone, 1998; Verdun, 1998; Verdun and Christiansen, 2000, 2001) and some economists (Lohmann, 1993; Gormley and De Haan, 1996). The height of the debate took place in the late 1990s. It has not really resurfaced recently. We can capture that criticism in the following simple claim:

> *Claim 3: EMU is illegitimate – requires more democracy, accountability and transparency.*

2.4 Does EMU need a common identity?

Related to this concern about EMU's legitimacy and democratic accountability was the question of whether EMU was introduced in a solid enough environment to be supported by the people at large. Constructivists started making the point that EMU was introduced to replace currencies that were much loved in the nation states. Risse et al. (1999) argued that in countries like Germany and the UK the national currency plays an important role in shaping the national identity. The argument about Germany was that the country did not have that much recent history to be proud of, but it did have a number of recent economic successes: its *Wirtschaftswunder* (economic miracle) and the very successful Deutschmark (DM) (the West German currency that led the pack of EMS currencies throughout the 1980s and it led the predecessor of the EMS (the snake) in the 1970s). In the case of the UK, hegemonic decline was something the people were still coming to terms with since the end of the Second World War. The prospect of giving up the British pound was seen as undesirable to the British people. Constructivists, such as Risse et al. (1999), made the point that it was a challenge to create a single currency in Europe without having spent time building a sense of collective identity, especially if one would be asking member states to give up their national currency in favour of this new

European currency without the people being able to transfer a similar sense of pride to that new currency. Authors such as Kaelberer (2004) take the analysis one step further and argue that even though the successful introduction of the euro requires that there be some common identity before-hand, the euro itself, in turn, is also part of the creation of a common public space and hence itself produces some identity formation. These points led to the following claim:

Claim 4: EMU needs a common identity to be stable.

2.5 EMU and welfare state retrenchment

Another line of reasoning that was often heard at this time was whether EMU would be influencing member states' capacity to determine their own welfare state policies. Many authors who were writing on globalisation and 'neoliberalism' argued that the welfare state was at risk. Not only EMU would cause welfare state retrenchment but also other trends would have the same effect. The fear was that there would be a race to the bottom in terms of public expenditure on welfare states as a result of two mechanisms: first, competition between member states for investment would drive taxes down (thus generating fewer state revenues); second, the same pressures would also drive social security premiums down so as to ensure that employers were not paying too much in non-wage costs that affected their cost structure. The result was a prediction that EMU would cause welfare state retrenchment (Leander and Guzzini, 1997; Rhodes, 1997):

Claim 5: EMU will lead to welfare state retrenchment.

3 The creation of EMU in the EU: economists' warnings

Some of the economists shared the above-mentioned claims that for the most parts were made by political scientists, but economists in turn had their own points to look for. They ranged from a warning against gloom and doom to problems about governance. In the following, the author will discuss five claims. The claims discussed here

1 EMU will lead to war
2 the need for EMU to be introduced in an optimal currency area
3 the ECB is weak
4 rigid rules of the Stability and Growth Pact (SGP) will stifle growth; and finally
5 issues surrounding the euro as an international currency.

3.1 EMU and war

The first and boldest claim about looming EMU gloom and doom was articulated by Martin Feldstein in an article published on 13 June 1992 in the influential weekly British magazine *The Economist* (Feldstein, 1992). His views were then very outspoken and reached many people. Feldman's analysis was that there was insufficient federalism to merit moving so far into joint governance that he could see no other outcome than warring parties (see also his more scholarly articles (Feldstein, 1997), which do not fundamentally differ from his 1992 interpretation of EMU being a risky project).

It led to the simple claim (not supported by many people but focally presented by Feldman in that *Economist* article, and cited by many since), which stated that war was inevitable if countries were insufficiently politically integrated.

Claim 6: EMU will lead to war.

3.2 EMU and the optimum currency area debate

Some of the literature on EMU in the early 1990s dealt with the question of whether EMU, once created, would contain the right countries. The main point was that if countries were to join EMU, and if they were not sufficiently integrated, the cost of EMU would be high for those not in tune with the others. The UK was one such country that was judged to have a business cycle not in sync with the greater DM-zone. The other element of the Optimum Currency Area (OCA) literature, based on the seminal work of Mundell (1961), McKinnon (1963) and Kenen (1969), was that with the exchange rate instrument (devaluation/revaluation) gone and the interest rate in the hands of a centralised authority, member states would no longer have at their disposal a number of tools important for macroeconomic adjustment. Lessons learnt from other federations (e.g., Canada, USA, Australia), as well as at the time unitary states (UK) suggested that if monetary policy is set for the country as a whole, it could be detrimental for the part that is out of line with the rest of the country. The argument was that if there was a severe downturn in a part of the country, these instruments that are centralised could not be used for the particular part of the country that is not doing so well. The OCA literature suggested that these nation states are typically equipped, to some extent, to deal with the situation by having a few other instruments (for instance labour mobility), but there are also other automatic stabilisers, such as the fact that the government revenue generated in an area in decline will be lower (fewer people are working and thus the government is collecting less money in unemployment premiums and so on). In most cases, the central government jumps in with some investment or increased expenditure (through unemployment payment; perhaps, some financial transfers for other projects or simply a grant to the region). The OCA literature found that most federations did not perfectly fit the OCA criteria (Sachs and Sala-i-Martín, 1993). But, it was clear that the EU had more difficulties to fit the criteria because of low labour mobility (because of the language barrier, cultural practices and impediments to European cross-border labour mobility owing to the language barrier, the absence of a clear system of recognition of credentials, lack of recognition of pensions, unemployment benefits and so on). Other factors include the lower impact of automatic stabilisers because of the small size of the centralised EU budget and so on (see Eichengreen, 1993; Bayoumi and Eichengreen, 1994). The conclusions economists drew based on the above-mentioned discussion are that the EU will more likely find itself having started an EMU that will not be beneficial for most countries all the time, and thus due to the problems indicated earlier might collapse once the going gets tough.

Claim 7: Participating countries need to be in an optimum currency area in order for EMU to work.

3.3 A weak central bank

The next heading of critique was directed at the ECB. From the late 1980s onwards, there had been voices that expressed concern about the ECB in all kinds of ways. The first set of criticisms were that the ECB would be a weak actor from the outset because it would take a long time to build up credibility (cf. De Haan et al., 2004). The reasoning was that most central banks take time to establish themselves. All of the successful central banks in the world started off having to prove themselves as solid. Why would this central bank manage to be successful from the get go? The second set of criticisms related to the statutes of the ECB and to some extent the problem with the no-bail-out clause. This clause suggested that if a country (government) went bankrupt, then the ECB would not 'bail-out' this country. Critics argued that such a statement was not credible (cf. Masson and Taylor, 1993). They pointed to the fact that EMU is part of a greater political package, and that thus if a country were in such dire straits that it could benefit from a bail-out, then it would be very likely that the ECB would bail the country out. If that were the case, then the market mechanisms that would price the cost of government bonds in the market differently, reflecting the likelihood that a particular country could at some point not be able to pay back. Countries that ran a higher risk of running into problems were those countries with a debt to Gross Domestic Product (GDP) ratio of more than 100% – such as Belgium and Italy. A third set of criticisms about the ECB was that its mandate was too narrowly focused on price stability – even though the statutes stipulate that without prejudice to that objective the ECB should seek to support the general principles of the EU (article 2 of the Treaty on European Union), which basically aims at economic growth, high employment and so on. The critics argued that some of the most successful central banks (such as the Bank of Canada, the US Federal Reserve Bank and so on) had a combination of objectives so that they could try to promote economic growth even if it were to affect inflation. The critics were afraid that the ECB would be less effective if it were only trying to secure price stability. These points together could be summarised in one sentence:

Claim 8: The ECB will be weak.

3.4 EMU and the SGP

The next set of criticisms focused on the Stability and Growth Pact (SGP). This body of rules that seeks to deal with the lack of a centralised economic government at the European level and the fact that monetary and fiscal policies need to be coordinated has seen the most criticism by economists of all aspects of EMU design (see Savage and Verdun, 2007 for criticisms and for a list of suggested policy solutions). Many economists have criticised the SGP for being 'stupid', 'ridiculous', 'insane' and the like. The SGP can be summarised as follows (see also Heipertz and Verdun, 2004, 2005, 2006, 2010). Member states have to keep their budgetary deficit and public debt spending under control, and in particular below targets set out in the Maastricht Treaty. So, the annual percentage of the budgetary deficit as a ratio of GDP should remain under the 3% ceiling; the accumulated public debt as a percentage of the GDP at any time should remain below 60% of GDP or be moving in the right direction. If governments of member states fail to meet, in particular, the 3% budgetary deficit rule (this was the one that was felt that the government of the day could have some influence over, as opposed to the public debt that has been accumulating over time), then a country would have to correct the imbalance in a timely fashion, or witness some kind of sanctions (first, a non-interest incurring deposit, which later can be transferred into a fine). The criticisms focused on two aspects of these arrangements. First, the countries that are exceeding the 3% reference value are more likely doing so in a context of economic downturn or slow down. Normally, under those circumstances, the governments of these countries would need to pursue countercyclical policies (in a downturn spend more, tax less) rather than procyclical policies (in a downturn spend less, tax more). Thus, the critics said that such perverse policy goals were unwise and should not be supported. The main criticism can be summarised as follows:

Claim 9: The SGP will stifle growth.

3.5 EMU and the value of the euro

Finally, the last set of criticisms that were heard regarded the euro. Similar to the argument mentioned earlier regarding the ECB, it was argued that successful currencies typically need some time to prove themselves. Thus it was naive to think that the euro could just be introduced and that the rest of the countries would use that currency with the same amount of confidence as they would have used the DM before or the US dollar if one wanted to do business in a major international currency. Even if not that much attention had been given to the value of the euro in the early years of the 1990s, before the euro was introduced various analyses were available that talked about how it would take time for the market to trust the euro as it did the currencies that went before them (especially the DM, French franc, etc.). The argument was that the cost of having the euro still might be high as the insecurity about the currency and its value would be priced into the currency and the borrowing and lending in that currency. Ironically, the criticism was also there even as the euro was doing wildly different things. The criticism emerged in all its intensity in the early years that the euro existed when the euro went down to $0.82 to the US dollar. But, it was also criticised as the euro passed parity and reached $1.60 to the US dollar. In fact, with the euro valued anywhere in between $0.82 US and $1.60 US, someone was criticising the value of the euro and what it was doing to the export/import sector.[1] The above led to the following criticism:

Claim 10: The euro will be too weak/strong (depending on the views).

4 An evaluation of the ten claims

Let us now turn to each of the ten claims and see what has become of those claims.

Claim 1: EMU will only survive if it remains in the interest of the large member states.

The claim about the need to maintain the support of the large member states is a little difficult to assess without first offering an operationalisation of the question of what the ‘interests’ *are* of the large member states. The first point perhaps is to make the obvious point, which is that the UK to date has not joined EMU. This can be interpreted in a few ways.

First, it basically undermines the claim. The UK clearly is a large member state. If that country has not seen it to be in its interest to join, and it is not in, then clearly EMU has not needed the UK (one of the four largest countries) to be in. The counterargument to this point is that this country's interest back in the early 1990s was to take part in the *negotiations*, but not to commit in advance to joining. So from that perspective one could reinterpret the claim and say that EMU has to be in the interest of the large member states, *minus UK*, in other words, in the interests of Germany, France and Italy.

If one is to look at these countries and determine whether it is in their interest, the first and simple observation is that none of these three countries have seriously challenged being in EMU (there was a temporary moment that some officials in the Italian government speculated about thinking EMU was not attractive and argue that Italy should stay out – which was quickly put aside as ridiculous, as the reintroduction of the lira would be too expensive and the currency could well go into a tailspin. Besides those volatilities, it would become very costly for the Italian government to attract money on the international capital markets).

Yet another way to operationalise the question of how EMU is in the interest of the large member states is to assess whether the policies of the ECB (interest rate) are appropriate for the large economies. On the basis of that interpretation, one could argue without difficulty that monetary policy in the euro area in the period 2001–2006 was not entirely appropriate for Germany, as that country would have benefited from lower interest rates given its weak growth and low-inflation rates. France and Italy were more in line. But again, monetary policy was not very much out of line with the monetary policy a central bank would have set based only on German aggregate statistics.

Another interpretation is to assess how to interpret what 'EMU' means in this regard, in particular insofar as EMU enlargement is concerned. One could argue that the large member states have an interest in keeping EMU as small as possible (once it was started with 12 member states) so as to ensure that the large member states are the ones most influential in determining the policies of the ECB. In fact, the expansion of EMU has been carefully considered (for instance when Lithuania was refused entry in 2006 with only a marginally poorer performance on inflation. But, the economic size of Lithuania was so small that even if it had joined the aggregate inflation statistics of the entire euro area would not have significantly altered because of Lithuanian participation. A bigger concern could have been what signal it would have given other prospective candidates who were coming very close but not perfectly meeting the inflation criterion). If that was the case, EMU interpreted this way is in the interest of the three large member states already in EMU: Germany, France and Italy.

Finally, in light of the recent banking and stock exchange crises and the subsequent turbulence in the currency markets (autumn 2008), one can say that EMU has protected the exchange rates of all those in the euro area. Those EU member states outside the euro area all saw a deterioration of their exchange rates (not only the three EU-15 outs – i.e., Denmark, Sweden and UK – but also the Baltic States and other Central and Eastern European states). The extreme case was that of Iceland, which saw its economy, and indeed the country as a whole, on the brink of economic collapse. The euro lost some of its value against the US dollar but other European currencies experienced much stronger depreciations although in 2009 the euro picked up a little again against the US dollar. Public opinion and government stance towards the euro in the three EU-15 outs changed somewhat over this period with more people than before leaning towards favouring eventual euro adoption. The conclusion drawn from this experience with exchange rate turmoil in autumn 2008 is that the euro area offers a buffer in times of financial difficulty. As such, it is in the interest of large (but also smaller member states) to have the euro as a protection against financial turmoil.

In summary, depending on how to interpret this claim, one can argue that EMU has been in the interest of the three large member states already in EMU. It also needs to be observed that the UK has not been in EMU and thus one needs to conclude that it had not been in the interest of the UK to join (although one could counter this argument by stating that it could very well be that having EMU but not joining it, was very much in the interest of the UK) (Baldwin, 2005, 2006).[2]

At this point, we have not seen any large country (or any small country in EMU) that argues that EMU was not in their interest. So, we cannot examine the validity of this first claim. Let us now turn to the second claim.

Claim 2: EMU needs an Economic Government (or Political Union) or it will become unstable.

To assess this claim, we first need to operationalise what 'unstable' means. To some extent, the developments in the first few years of EMU may be seen as unstable insofar as the Stability and Growth Pact (SGP) is concerned. The issue here is that the French and the Germans managed to interrupt the rules of the Excessive Deficit Procedure of the SGP and buy themselves time. The problem with this analysis is that EMU did not show terrible signs of stress (the euro almost did not respond to the SGP crisis, financial markets were stable and so on). Furthermore, one cannot say that the SGP regime was fully undermined by what happened at that Council meeting on 25 November 2003. The reforms of the SGP completed in 2005 merely enabled countries some more flexibility, but they did not show a clear sign that EMU was crumbling. If anything, by 2007 it seemed that most countries had accepted the broader SGP regime and were incorporating in their daily business the medium-term objectives and the reference values for excessive deficits.

Another observation is that there have actually been a few smaller moves towards closer economic government or political union, albeit baby steps. The eurogroup – the group of finance ministers from the euro area countries – meets before the ECOFIN Council meeting and seeks to coordinate fiscal policy. As such, the informal network has been strengthened and has managed to compensate a little for the lack of political union or economic government (see also Puetter, 2006).

So, the assessment that EMU would become unstable without further institutional change in the area of political union or more centralisation of economic government did not seem to be a necessary condition based on the experience of the first ten years of EMU.

Claim 3: EMU is illegitimate – requires more democracy, accountability and transparency.

This claim has been mostly silenced over the past decade. Those who have tried to restart this debate in recent years have found it difficult to add anything to the very academic debate of the late 1990s. The reason being that some authors have successfully explained that the ECB has been given a democratic mandate (i.e., provided to the ECB by democratically elected bodies, national parliaments and national ministers), the statutes were incorporated in the Treaty that, in turn, was signed by heads of states and ratified by parliaments. Furthermore, there have been numerous occasions in which the statutes could have been changed, as the EU was going through constitutional change with the Amsterdam and Nice treaties, with Treaty Establishing a Constitution for Europe and the Lisbon Treaty. On no occasion was there a strong enough desire to change the statutes of the ECB. Even if the French sometimes talk about the need for a *gouvernement économique*, other member states do not want that French concept to mean that the ECB's mandate should change. As Majone (1998) and others have shown, the ECB has been granted a mandate very much like a constitutional court would be or an independent regulatory agency. If one is unhappy with that mandate, one should change the mandate. So far, the majority feels that it is important that the ECB has the independence to secure its monetary policy. Having said that, the French government has often run on a platform of bashing the ECB and its mandate. One could argue that the Constitutional Treaty suffered in the French referendum from some advocates making the case that the ECB should be less independent. Even so, one could hardly claim that *EMU* has become unstable because of this referendum result in France in spring 2005. In sum, EMU has not become unstable because of any feeling about a lack of transparency, accountability or credibility of EMU.

Claim 4: EMU needs a common identity to be stable.

The claim for the need for a common identity is a little tricky to assess. First, EMU did not become unstable over the first ten years, so perhaps one could argue that whatever be the role of the common identity, it was not required for EMU to be successful. Eurobarometer studies do not show a major change in identity formation in the EU over the past ten years (Verdun 2010). However, these same studies do show support for the thesis by Kaelberer (2004) namely that the euro is part of the creation of a common identity. It is probably safe to say that there is insufficient evidence to demonstrate (or for that matter, to demonstrate the opposite) a clear link between EMU stability and common identity. What is remarkable, however, is that the three EU-15 'outs' (Denmark, Sweden and UK) are still outs at the time of writing. The observation there is perhaps that the identity argument might make a difference as to why these countries may not be in. But, it is fair to say that EMU stability did not require those three countries to be a member.

Claim 5: EMU will lead to welfare state retrenchment.

An interesting study by Bolukbasi (2007 and see also Bolukbasi, 2009) suggests that although most of the literature supported the claim that EMU will lead to welfare retrenchment (and that this literature mostly felt this was a 'bad' development), the actual empirical studies of the amount of money spent on welfare state expenses throughout Europe in the period since EMU started has gone up rather than down. In other words, it is difficult to find support for the claim made here. Of course, it could very well be that the counterfactual (how much would governments have spent on welfare state expenditure *without EMU*) could have very well have been more. But, the fact is that despite EMU welfare state expenditure did not go down. Also, the quality of expenditure and of the welfare state does not appear to have been reduced by all that much (if at all). There have been some changes in the allocation of funds in welfare states but some of those reallocations had to do with cost control in an environment that requires higher expenditure owing to the ageing population and so on.

In other words, we cannot find support for the claim that EMU caused welfare state retrenchment in the sense that it undermined states' capacity to have a welfare state of their liking.

Claim 6: EMU will lead to war.

This claim was of course purposefully exaggerated. But, Feldstein intended to make the point that the creation of EMU could lead to more animosity than the non-EMU situation and also that EMU could easily break up. The first ten years of EMU clearly did not lead to a major point of tension that in any way looked as if EMU was breaking up. The major point of tension was the SGP debacle in 2003 and its reform in 2005, but it was never a serious enough case that could threaten the existence of EMU.

Claim 7: Participating countries need to be in an optimum currency area for EMU to work.

This claim was discussed in great detail prior to EMU coming into existence. In fact, on the basis of this debate, it became clear that it would be the best if EMU started with a group of countries that represented the larger DM-zone, i.e., Germany, Benelux countries, Austria, Denmark and so on. However, in the course of the late 1990s, it became a political reality that countries not traditionally conceived of as belonging to this smaller core group would be equally keen to join (such as Italy, Spain, Portugal and Greece) and could for political reasons not easily be excluded. When this scenario became clear, the Germans initiated the plan for a Stability Pact, which eventually became the SGP, agreed to in 1997. The very aim of that Pact was to ensure compliance to fiscal prudence once EMU had started (Heipertz and Verdun, 2010).

The EMU of 11, which started in 1999, was not an OCA. Throughout those early years of EMU, more scholars reflected on the need for countries to be part of an OCA for EMU to be stable. The current research suggests that to some extent EMU membership is part and parcel of the development of an OCA (i.e., endogenous, see De Grauwe, 2006). Of course, not all federations are OCAs, but they do have the extra ability to adjust to shocks through fiscal federalism, as was noted earlier when discussing the rationale for a *gouvernement économique*, which EMU cannot take advantage of in the same way as a federal state. The situation could have been more challenging had the UK joined EMU. This country has for many years had a business cycle not in sync with that of the average of the EMU countries (Artis, 2006; Howarth, 2006), even though in recent years the business cycle of that country has become more synchronised with that of the euro area. Some recent research suggests that being part of EMU may not further synchronise the business cycles of those countries in EMU (Gouveia and Correia, 2008). Be that as it may, so far, one cannot observe a problem with EMU countries not forming an OCA.

Claim 8: The ECB will be weak.

Let us operationalise, along the lines done in the discussion in the previous section, what it means that the ECB would be weak. Let us break the claim down into three smaller subclaims:

1 it will take a long time to build up credibility

2 the ECB no-bail-out clause is not credible

3 the ECB mandate was too narrowly focused on price stability inflation so as to jeopardise.

All three subclaims together would paint a picture of an incapable central bank, obsessed by price stability.

The first ten years of EMU have seen that ECB was trying to be very predictable about its policies. Many observers have taken the line that the ECB is ‘boring’, ‘slow’, unnecessarily lacking ‘creativity’ and so on. The point the ECB governing board has tried to make, however, is that it needs to be predictable and that way build up credibility. The financial markets could easily be confused by what the new central bank would ‘stand for’ if it did not have a clear, predictable, even boring behaviour. The ECB chose to be boring as a strategy to build up credibility.

Regarding subclause 2, the question of whether the no-bail-out clause is credible or not was not put to the test in the first ten years of post-EMU. But, if ever it is to be challenged in the short to medium run, it will more likely be the immediate future as the result of the financial market crisis unfolds (see below).

Finally, with regard to the third subclause, the ECB mandate was too narrowly focused on price stability. Many critics have made this point. It is a little misleading because the mandate of the Eurosystem is that it should ‘without prejudice’ to the objective of price stability support the general objectives of the European Union as stipulated in article 2 of the Consolidated Treaties. These objectives include economic growth, employment and a fair spread of economic development across regions and sectors. In other words, to make too much of the price stability mandate is to miss the fact that the ECB could very well seek to target other goals provided it is not causing a projected increase inprice stability. Let us turn to an assessment of the euro area performance when discussing claim 9.

Claim 9: The SGP will stifle growth.

Not only the ECB has been criticised for possibly not being proactive enough on growth but also the SGP regime has been criticised even more for failing to allow member states to follow countercyclical policies in economic bad times. The claim is that the macroeconomic rules set up to ensure fiscal policy coordination would stifle growth. Let us see what we can learn about it.

If one was to examine whether the economies of the euro area have fared well in the first ten years of EMU, one would need to devise a set of criteria to offer a judgement. One such criterion could be to compare the economic growth per capita of the euro area countries with those of the three EU-15 outs (Denmark, Sweden and the UK). Such a comparison puts the three outs ahead of the euro area (at least an analysis that excludes the years 2008 and projections for 2009). Another comparison would be the euro area countries compared with the new member states that joined in 2004 and 2007. Again, we see the average growth of these new entrants at higher levels than the euro area countries. Finally, we could compare the euro area economy performance with the other leading industrialised economies (USA, Canada, Japan, etc.). Again, we do find the average of these other economies outperforming the euro area (see Table 1).

Table 1 GDP per capita (percentage change on preceding year, 2004–2009)

	2004	*2005*	*2006*	*2007*	*2008*	*2009*
Belgium	2.5	1.3	2.3	2	0.7	–0.6
Germany	1.2	0.8	3.1	2.6	1.9	0.1
Ireland	2.9	4.1	3.1	3.5	–3.4	–1.8
Greece	4.6	2.5	4.1	3.8	2.8	2.2
Spain	1.6	1.9	2.3	1.8	0	–1.4
France	1.8	1.3	1.6	1.6	0.4	–0.5
Italy	0.5	–0.2	1.3	0.8	–0.2	–0.2
Cyprus	1.8	1.5	2.1	2.7	2	1.3
Luxembourg	3.1	3.6	4.8	3.6	1.6	0.3
Malta	0.4	2.9	2.3	3	1.9	1.5
The Netherlands	1.9	1.8	3.2	3.2	2.1	0.2
Austria	1.8	2.1	2.8	2.6	1.6	0.3
Portugal	0.9	0.5	1	1.7	0.3	–0.1
Slovenia	4.2	4.2	5.5	6.2	3.7	2.7
Finland	3.4	2.6	4.6	4.1	2	1
Euro area	1.5	1.1	2.3	2.1	0.9	–0.2
Bulgaria	7.2	6.8	6.6	6.2	7	5
Czech Republic	4.4	6	6.4	5.4	4.2	3.4
Denmark	2.1	2.2	3.6	1.2	0.4	–0.1
Estonia	7.5	9.8	10.6	6.5	–1.2	–1.1
Latvia	9.3	11.2	12.9	10.9	–0.3	–2.2
Lithuania	7.9	8.5	8.5	9.5	4.2	0.2
Hungary	5.1	4.2	4.3	1.2	1.9	0.8
Poland	5.4	3.7	6.3	6.7	5.4	3.8
Romania	8.7	4.4	8.4	6.3	8.8	5
Slovakia	5.1	6.5	8.4	10.3	6.9	4.8
Sweden	3.7	2.9	3.5	2	0.2	–0.7
UK	2.3	1.4	2.2	2.7	0.5	–1.4
EU 27	2	1.5	2.7	2.4	1.1	–0.1
USA	2.7	2	1.8	1	0.6	–1.4
Japan	2.7	1.9	2.4	2.1	0.4	–0.3

Source: European Commission (2008) Autumn forecast, Table 4, p.143

Even though this assessment does not put the euro area in a very positive light can one really make a judgement already about euro area performance? The largest euro area economies witnessed the need for structural reform in the early years of the new millennium independent of EMU (take the case of Germany). Furthermore, many countries still needed to go through an adjustment to EMU, in particular those countries that still had to become used to not having the devaluation instrument to remain competitive (Italy is a case in point). By 2007, the euro area economies seemed to have caught up with the performance of other leading economies. Nevertheless, the year 2007 was characterised by high growth and thus the SGP was not affecting fiscal policies. The assessment is not completely fair if one is to look at the negative effects of SGP as 'growth stifling'. Clearly, given the lack of an economic government, one needs some kind of coordination device. If member states are fiscally prudent, the chance of having to turn to procyclical policies in a downturn is low. However, one looks at the facts that there is still not enough data to make a proper judgement on growth performance in the euro area. One needs to do the exercise again in ten years to make more sense of the comparisons.

Claim 10: The euro will be too weak/strong.

The value of the euro was not really a topic discussed at great length at the beginning of the 1990s. When speculations came out about the possible external value of the euro, once created, they first predicted that the euro would be steady (given that it was effectively supposed to replace the DM and was backed by a central bank that was modelled after the Bundesbank). When the euro first devalued vis-à-vis other major currencies, there was much criticism about that result not having been anticipated. It was seen as a blow to the euro. However, since its rise and further strengthening in 2007 and the first half of 2008 and even its relative stability during the turmoil of the second half of 2008, it is clear that the euro has secured a niche for itself not only in economic transactions in the euro area and surrounding but also in international markets.

One side effect that was not anticipated was that the introduction of the euro would have such a major effect on the development of a European bond market (Pagano and Von Thadden, 2004). EMU also had effects outside the euro area. The effects, even after only its first year, included a wider use of the euro than originally anticipated (Danthine et al., 2001). By 2008, the euro has been used as a reserve currency and international trading currency in an ever-larger part of international trade and transactions. There are more banknotes and coins circulating in euros than in US dollars, which has been the case for a few years now (*Financial Times*, 2006; *Business Week*, 2008). Overall, the concerns about the euro as a weak performing currency or even one that is overly overrated did not materialise. Moreover, those who worry about the external value of the euro are often reminded that the euro area as a whole (just like the USA) is a relatively closed economy. The importance of over- or undervaluation of a currency of a small open economy is typically worse than that for the euro area as a whole vis-à-vis the rest of the world.

5 Conclusions

This paper set out to assess ten critical claims heard about economic and monetary integration in the run up to the start of EMU in 1999. We have seen that the risks envisaged by critics did not materialise over the past ten years. As a way to draw the paper to a close, this section offers some speculative reflections on whether any of the ten claims might play out in the context of the recent financial crisis and what may lie ahead.

The world was shaken up dramatically in the fall 2008 by a credit, banking and stock exchange crisis, which became the apex of the financial crisis that had started in August 2007. The crisis was triggered at first by the fall-out of the subprime crisis in the USA and eventually by September and October 2008 it affected the entire financial sector. Following the bankruptcy of Lehman Brothers in mid-September, the financial crisis worsened and led to a sudden immense downfall in the value of stocks of unprecedented magnitude (worldwide approximately 30% in two months). Many banks were at risk of becoming bankrupt. Banks were bailed out by their national governments and central banks or outright nationalised. At various points, interbank lending dried up. The governments of countries of the euro area first responded with independent action but eventually realised the importance of joint action. These events showed the importance of coordination of the fiscal authorities given the lack of a centralised economic authority at the European level.

The ECB responded quite forcefully at different stages. Already back in August 2007, the ECB acted by providing ample liquidity in the market by offering low rate overnight interbank loans when credit was drying up. On 8 October and 6 November 2008, the ECB was part of a coordinated effort with the central banks of other major countries to reduce interest rates (*Financial Times*, 2008). Overall, it appears that the ECB has responded to the crisis by being responsive to the credit needs of the economy. The ECB has also offered financial packages to countries outside the euro area that experienced problems.

To date, the stresses on the system seem to still be under control. Even though some in the media have speculated that EMU is at the risk of falling apart (*Globe and Mail*, 2008; *Financial Times*, 2009), scholars and policy makers are still convinced that the cost of break-up would be unacceptably high for any country currently in the euro area.

Another indicator of stability amidst the financial crisis is that the pressure on the euro exchange rate has not been high. In October and November 2008, the US dollar suddenly gained strength. Observers have pointed to the increase in funds transferred from all over the world to purchase US bonds (seen as the last safe haven). Note that many European banks also deposit funds overnight at the ECB – a sign that the private sector has great confidence in the stability of that institution. The relevance of the stability of the euro exchange rate is that under similar (indeed under less adverse) circumstances in the past European exchange rates responded with great volatility. In other words, the first signs of what the euro and EMU are doing for EU member states are positive. There can be no doubt that as the financial crisis turns into a recession – possibly a very deep recession, or even a depression – that the EU will be in for hard times. It will be interesting to see if institutional change will emerge in any of the areas that the critics have pointed to as being the weaknesses of EMU.

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Notes

[1]Finally, another criticism that came out in the new millennium following the introduction of the euro was that the introduction itself led to unreasonable price increases. This phenomenon was not feared so much before the euro was introduced but was voiced more focally in the early years in which the currency was introduced.

[2]In fact, according to Baldwin (2006), the three EU-15 'outs' (Denmark, Sweden and the UK) have benefited much from having the large integrated market next door, even if they were not members themselves. According to his calculations, these three countries saw their international trade (to the euro area) increase with 15%.

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