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European Monetary Union at Ten: Had the German Maastricht Critics Been Wrong?

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Abstract

Against the background of the euro-sceptic view many German economists expressed during the 1990ies and the traditional as well as modern debate on the optimum currency area the outcomes of the first ten years of the European Monetary Union are analysed. It is checked to what extent the concerns raised by Maastricht critics have been justified, or rather, to what extent the feared risks have not (or have not yet) materialised. It is shown that some of the alarming risks of the European Monetary Union that had been predicted in the 1990ies have emerged in the meantime – even though they have not yet essentially affected the euro's stability. But it remains to be seen whether, or rather how, the euro – within the framework of a non-optimal currency area – will overcome the challenges of the global financial and economic crisis without a loss of stability.

Keywords: Euro, European Monetary Union, Maastricht Treaty, Optimum Currency Area

JEL classifications: E5, F3

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1. The Euro – a Historically Unique Experiment

The inception of the European Monetary Union with the introduction of the euro in January 1999 was regarded as a historically unique experiment. For 11 heterogeneous and sovereign nations the euro became the common currency. Autonomous monetary policy was given up and the newly established European Central Bank was vested with the sole authority to set it. No other similar currency unions exist; those that were established never lasted long.[1] At the turn of the year 2008/2009, the first – relatively unstressed ten years of the European Monetary Union were acknowledged in many publications drawing a positive balance of the euro. At that point in time above all the euro was still considered as a stabilising anchor. However, just a few weeks later, at the beginning of February 2009, the first comments appeared pointing at the feasible risk of the monetary union's break-up. This danger was seen as the result of the increasing public debt and impending illiquidity in some countries caused by the economic stimulus packages designed to counteract the world-wide recession. Thus the question arises: Is the European Monetary Union the asserted "safe haven" or not yet crisis-proof?

In the run-up to the currency union the chances and risks of this far-reaching monetary integration were hotly debated. Especially from the German point of view many economists felt that giving up their own trust-worthy and hard currency was too high a price for the promised intensified economic and political integration that the new single currency should deliver. Their concerns were expressed in two manifestos that, directed to the public, forced politicians to look closer into the economic effects of the planned monetary union.

The first manifesto, "The Monetary Resolutions of Maastricht: A Danger for Europe", was signed in 1992 by 62 German professors of economics.[2] The second, "The Euro Comes Too Early", followed in 1998 with over 160 signatories.[3] The criticism voiced in these manifestos can be summed up as follows:

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[1] Earlier attempts to create currency unions between European countries that remained sovereign, such as the German-Austrian monetary union, the Latin monetary union or the Scandinavian monetary union in the 19th and the beginning 20th century ultimately failed because they were no political unions (cf. Theurl, 1992). Another reason for failure, when comparing with today's European currency union, was notably the lack of common institutions such as a common, independent central bank. Nor can the so-called franc zone with the West African currency union and the Central African currency union be compared with the European Monetary Union. The main goal of the franc zone is not to reach real and monetary integration between partner states but to stabilise the currency by tying it down to the franc and, in the meantime, to the euro respectively. Economic integration between partner states, however, is small-scale there.

[2] Published in the FAZ and the Zeit on the 11th June 1992 (see annex).

[3] Printed in the FAZ and the Financial Times on the 9th February 1998 (see annex).

- The Maastricht convergence criteria do not ensure an optimum currency area.[4]
- The Stability and Growth Pact does not suffice to assure the long term sustainability of the fiscal stability that is indispensable to the monetary union.
- Different national interests will put the independence of the European Central Bank into question time and time again.[5]
- A single monetary policy combined with the existence of heterogeneous economic structures could widen divergences within the union.
- The introduction of the common currency is likely to heighten competitive pressure on economically weaker European partners with marked tendencies towards inflation. The resulting increase in economic pressure could bring these countries to demand transfers as a kind of financial compensation.[6]
- The positive effects of the unified currency on the single market highlighted by euro advocates are overestimated.
- It is not to be excluded that the hoped-for political effects of monetary integration do not materialise and that the monetary union politically backfires.

Against this background euro-sceptics saw the danger of the euro becoming an unstable currency lacking internal as well as external stability, thus making the euro-zone a weak and delicate union, and ultimately hampering European integration instead of supporting it.

In the following it will be checked to what extent the concerns raised by Maastricht critics have been justified, or rather, to what extent the feared risks have not (or have not yet) materialised.

2. The Debate on the Optimum Currency Area

Most of the debate on the treaty of Maastricht was about who should be allowed to join the monetary union and who not – in other words, how to delimit an "optimal" currency area. In principle, the boundaries of a currency area are optimally set when the advantages of fixed exchange rates prevail within the union, whereas the advantages of flexible exchange rates dominate vis-à-vis third countries. Furthermore, precondition for an optimum currency area is the possibility of setting a monetary policy that suits all member states equally well, i.e. a

[4] See Ohr, 1993.
[5] See Caesar, 1992; Vaubel, 1993.
[6] See Eichengreen, 1992.

"one size fits all" policy (allocative efficiency). Moreover, efficiency in stabilization policies is necessary ensuring that the common central bank is willing and able to pursue a stability-oriented monetary policy which is not undermined by a destabilising behaviour of national governments or pressure groups.

For allocative efficiency it is essential that the economic framework within the individual countries necessitates the same monetary policy and that the single monetary policy unfolds identical real economic effects in each member state. If not, there should be other adjustment mechanisms that balance out the asymmetric effects of the single monetary policy and are capable of replacing the exchange rate as adjusting instrument in case of asymmetric shocks. Examples of such mechanisms would be a high flexibility of relative prices and/or a high mobility of production factors. In contrast, for the efficiency in stabilization policies the main prerequisite is an independent central bank with a clear mandate to pursue price stability.

The traditional criteria for determining an optimum currency area have long been known.[7] Already quite a long time ago, Friedman pointed out that a high price and wage flexibility is necessary if flexible exchange rates are to be abandoned as an adjustment mechanism.[8] However, the most well-known criterion is that of high factor mobility, especially labour mobility, which was formulated by Mundell in an article at the beginning of the 1960s:[9] Shifts of demand between countries or regions within a monetary union are unproblematic only if factor migration between these regions can take place. If this is not the case, the existence of different currencies with flexible exchange rates is more efficient. This criterion is sometimes referred to as Mundell I, as some years later Mundell brought a different one to the fore.

By contrast, McKinnon took a country's degree of openness as measuring stick for an optimum currency area.[10] The higher the share of tradable goods is the stronger are the effects of changes in the exchange rate on internal economic variables, so that countries that are highly economically integrated would do better to establish a common currency. Kenen too dealt with the question as how to define a currency area with which microeconomic disturbances could be absorbed the best:[11] The smaller the degree of diversification of production and consumption is the more necessary flexible exchange rates are, whereas, in

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[7] See also Mongelli, 2005

[8] See Friedman, 1953.

[9] See Mundell, 1961.

[10] See McKinnon, 1963.

[11] See Kenen, 1969.

case of a high degree of diversification, individual demand shifts have only a limited effect on economic variables, so that it would thus make sense to draw on the benefits of exchange rate stability.

Ingram[12] focused rather on macroeconomic criteria. He emphasised deep financial market integration as a main precondition for an optimum currency area. With deep financial market integration there is no need for the exchange rate as a mechanism ofr balance of payments adjustment as small changes in the interest rates are sufficient to cause balancing capital flows. Fleming[13] instead concentrated on the possible causes of balance of payments disequilibria, postulating that an optimum currency area necessitates an alignment of the inflation rates. This line of thought is similar to that of Ingram: Both laid emphasis on avoiding continuous balance of payments disequilibria within the currency area, in which the exchange rate can no longer serve as an adjustment instrument. Not to forget are also fiscal adjustment mechanisms, the significance of which has long been pointed out[14]:If a country in the monetary area is affected by asymmetric shocks, fiscal transfers from other member states could compensate the loss of the exchange rate as an adjustment mechanism.

The traditional approaches to the optimum currency area were developed at a time of capital controls and limited capital mobility. The main task of the exchange rate mechanism was to ensure balance of payments equilibrium through its influence on trade flows. In the meantime, however, due to the removal of capital controls world-wide, the increasing capital mobility as well as the large, speculative, capital movements that come with it, exchange rates are dominated more and more by shocks on the financial and capital markets. One of the first to include these developments into his considerations to the optimum currency area (however, without being properly perceived) was Mundell. In an article of 1973[15], sometimes also referred to as “Mundell II”, he explains that increasing capital mobility depletes the stabilising power of exchange rate flexibility. Instead, the exchange rate becomes a target of destabilising activities and, hence, itself a cause of asymmetric shocks.[16] Therefore, in the presence of a fully integrated capital market a monetary union is a good insurance against asymmetric shocks: Within a monetary union sources of income and wealth can be more intensely internationally diversified, the access to non-national credit markets improves and currency

[12] See Ingram, 1962.
[13] See Fleming, 1971.
[14] See Kenen, 1969.
[15] See Mundell, 1973.
[16] See also De Grauwe, 2006; McKinnon, 2004.

reserves are pooled. The argumentation, though, is not quite rigorous insofar as it implicitly assumes inefficient foreign exchange markets, but efficient financial markets.

Yet another criterion was derived from the experiences with very different inflation rates and stability preferences in the diverse countries, i.e. the existence of a “monetary anchor”. According to this criterion a currency union makes sense only if it manages to establish a lasting credible common monetary institution that guarantees previously instable countries credibility – by “tying their hands” upon joining the union.[17] The existence of such a “monetary anchor”, which continuously secures price stability after starting the monetary union, would hence eliminate the need for levelling inflation rates ex ante – as a precondition for an optimum currency area – as this would happen ex post automatically.

These considerations lead to the question as to what extent the optimum currency area has to be exogenously established right from the very start, or whether it could come about endogenously after having first created a common currency.

More trade, deeper financial integration, increased flexibility of labour markets and a better synchronisation of business cycles, which are all seen as effects explicitly resulting from the formation of a single currency, would point towards an endogeneity of the optimum currency area.[18]

Thus, the reduction in transaction costs and the improved price transparency which the common currency brings about are expected to intensify trade between member states. The more extensive the trade relations between the countries are, the more useful is the elimination of exchange rate risks through the common currency. In turn, falling transaction costs as well as the disappearance of exchange rate risks and the corresponding risk premiums generate further integration of the financial markets. This may improve the allocation of capital, lead to more efficiency and, as a result, facilitate insurance against asymmetric shocks. This, too, would strengthen the framework necessary for an optimum currency area. Equally, high labour market flexibility is an important requirement for an optimum area, insofar as it compensates – at least partially – for the loss of the exchange rate as “shock-absorber”. If, as a result of the creation of the common currency, price and wage transparency, and hence competition, increase, this could lead to more efficient labour markets, thus justifying ex post the formation of the currency area. Finally, a higher degree of trade integration as well as integration of financial and capital markets can reduce the risk of

[17] See Goodhart, 1989; Gandolfo, 1992.

[18] See De Grauwe/Mongelli, 2004

asymmetric shocks, which could, in turn, better synchronise the members' business cycles – another essential requirement for an efficient single monetary policy.[19]

Against the background of this discussion the next section will deal with the actual development in the first ten years of the European Monetary Union.

3. Target Achievement or Confirmation of Risks?

The main objectives of the single European currency may be summarised as follows:

- A reduction in transaction costs with subsequent positive effects on trade, financial integration, direct investment and growth in the currency area;
- An expansion of the market size, improved competitiveness and an increase in liquidity for member states;
- Less external disturbances of the now larger and more closed currency area and, therefore, more price stability;
- Enhanced efforts in fiscal and political unity with more internal „risk-sharing".[20]

The euro-advocates' argumentation in the matter based on the assumption of a hard new currency, thus, of price stability in the currency area and no significant risk of devaluation.

3.1 Price Stability, Real Exchange Rates and Current Accounts

In the following some of the most important developments in the euro zone are illustrated. Fig. 1 and 2 show the development of the euro exchange rate against the dollar and as the effective exchange rate (against the 12 most important trade partners) – each both as nominal exchange rate and as real exchange rate. After an initial period of devaluation, which lasted for two years and is attributed to the, at first, naturally missing reputation of the newly created currency, there followed a continuous trend of revaluation that was first stopped by the current financial crisis. The euro is therefore characterized by a relatively hard external value – at least until the global financial crisis started to take effect. Even the internal stability may be overall considered as guaranteed, notwithstanding the fact that the ECB's target value (a maximum inflation rate of two percent) was slightly exceeded nearly every year (see Fig. 3).[21]

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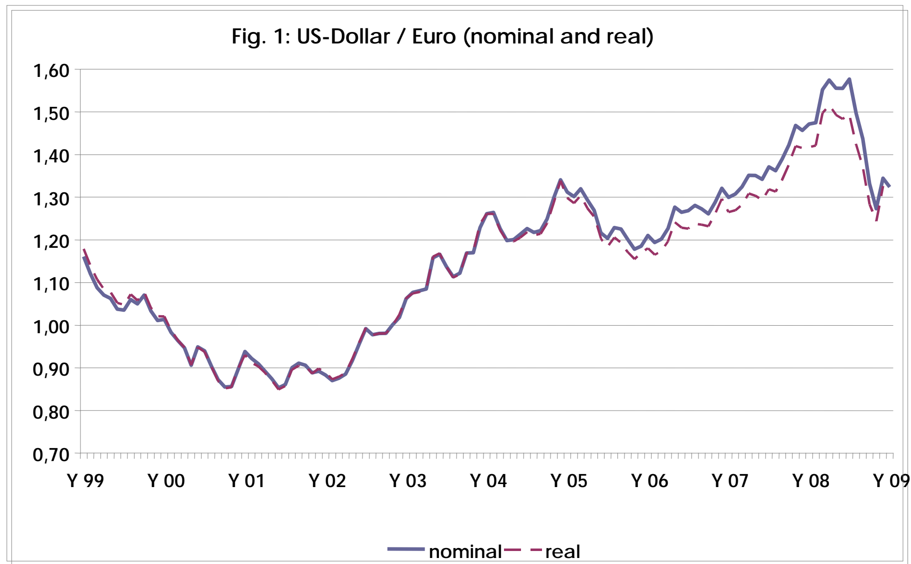
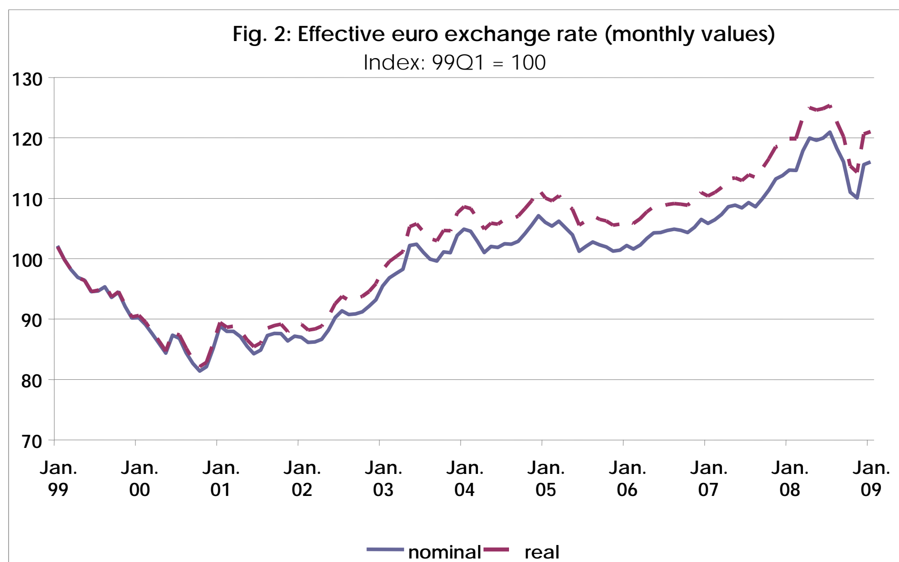
[19] On the other hand, however, it may be argued that increased trade integration might also lead to deeper specialisation and hence to the threat of more asymmetric shocks.

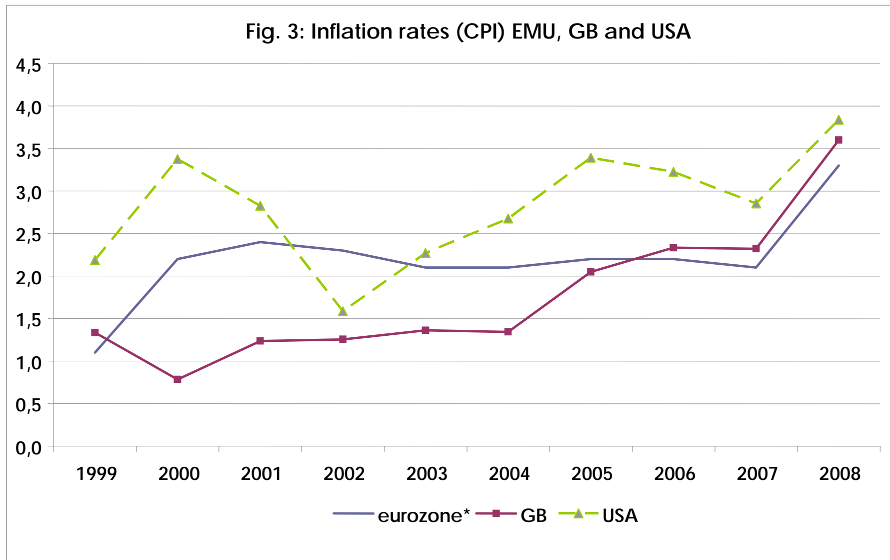
[20] See Goodhart, 2007.

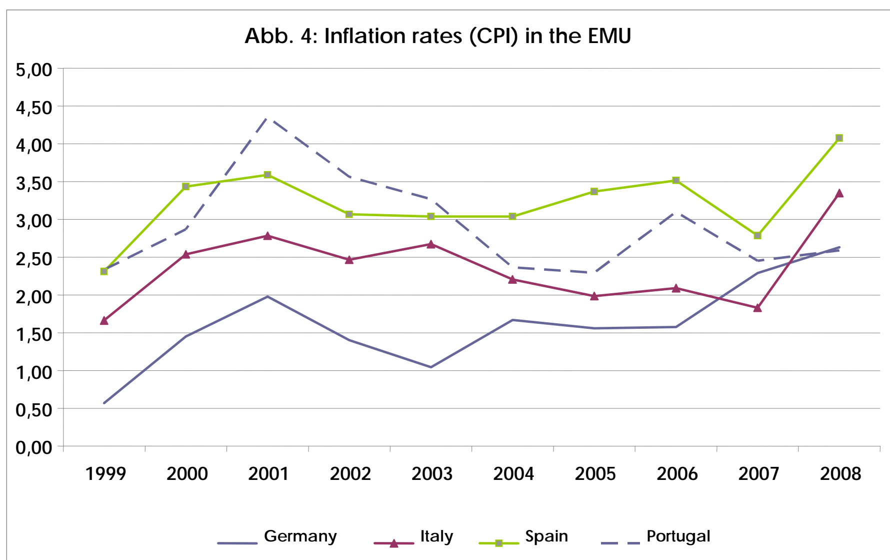
[21] In 2008 the exceedance was temporarily higher due to increased energy and food prices world-wide. Currently the trend is again strongly declining.





Data: EZB (2009), OECD (2009).





Data: OECD (2009)

In general, both a rapid trust building for the new currency as well as a fast gain in reputation for the ECB can be asserted. This fact is particularly strengthened by the increasing share of the euro in the global currency reserves (from 17.9 % in 1999 to 26.7 % in 2008).[22]

One alarming issue is that, although the average rate of inflation in the monetary union is moderate hitherto und mostly kept within the desired limits, the inflation rates of the individual members deviate, in part considerably, from the average. Divergences in inflation persist (see Fig. 4) with just the previously weak currency countries exhibiting the persistently high inflation rates and Germany, in contrast, generally the lowest ones.[23] The results are sustained and growing differences in price levels, as shown in Tab. 1. This divergence of price indices causes respective shifts of price competitiveness within the European Monetary Union.

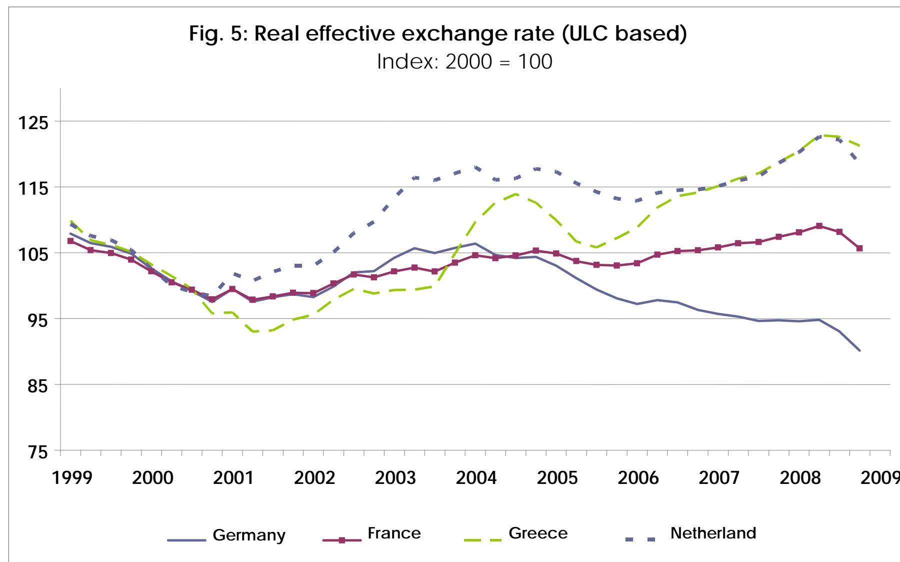
Tab. 1: Current inflation rates in the EMU and cumulated price development

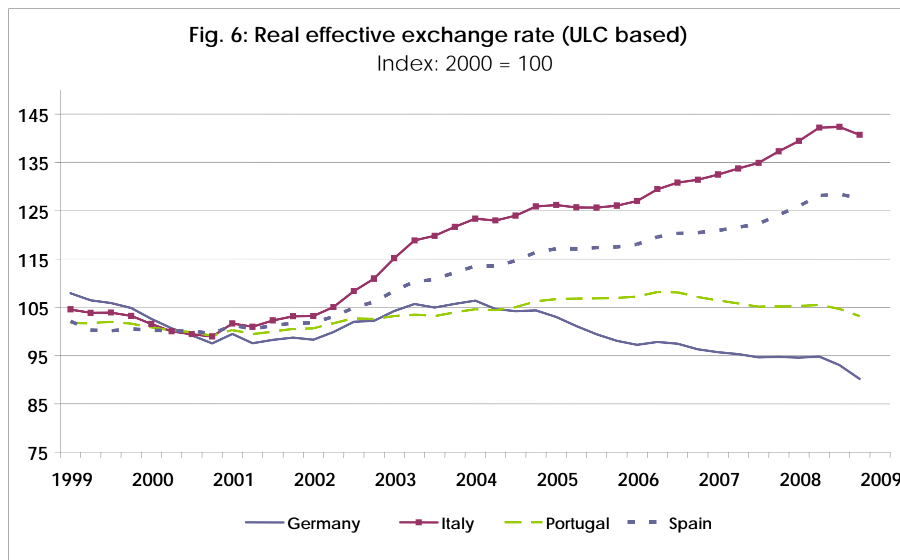
	Price index Dec. 2008 (2000 = 100)	Inflation rate (HVPI) 2008
Germany	**115.22**	**2.8**
Spain	**129.7**	**4.1**
Portugal	**125.8**	**2.7**
Greece	**131.2**	**4.2**
Ireland	**133.5**	**3.3**
France	**116.3**	**3.2**
Italy	**121.4**	**3.5**
Euro zone	**120.4**	**3.3**
Great Britain	**117.7**	**3.7**
Sweden	**114.6**	**3.3**

Data: eurostat (2009)

[22] See IMF, 2009. The share of the dollar decreased in the same period from 61 % auf 72.9 %.

[23] The divergences depend partially on the different business cycles but are mostly due to the different development of unit labour costs and the lack of willingness to undertake structural changes in the formerly weak currency countries. See De Grauwe, 2009; EU-Commission, 2009.





Data: OECD (2009)

By joining the monetary union, countries like Italy, Spain, Portugal, Greece and Ireland were able to reduce their exchange rate-based risk premiums and thus realise significantly lower interest rates. However, in the meantime this advantage has been more than cancelled out by the deterioration of their price competitiveness, which can no longer be counterbalanced by devaluating their currencies.

This development is also reflected in the real effective exchange rates of the member states. Moreover it is to be seen that the effects of the euro's external value on foreign trade varies greatly according to member state. Thus, Italian and French exports are more exchange rate-elastic than German exports, so that they suffer more from the revaluation of the euro, whereas in the last few years Germany's highly income-elastic exports greatly benefitted from the positive economic situation world-wide.[24] It therefore becomes clear that national interests differ even with respect to the euro exchange rate, which could in turn lead to different requests as regards the policies of the ECB.[25]

Fig. 5 and 6 for instance show for Germany a significant real devaluation since the beginning of the monetary union, whereas countries such as Greece, Italy or Spain strongly appreciated.[26] Accordingly, significant deteriorations in the external balances resulted for Greece, Spain and Portugal while Germany and the Netherlands for example experienced big surpluses (see Tab. 2).

However, in a monetary union with a single currency it is precisely the current account (and no longer the balance of payments) that could become a source of instability. Financing persistently high current account deficits implies a transfer problem, which in case of a crisis could result in a "sudden stop" or even capital flight.[27] Against the background of still existent significant per-capita-income differences within the monetary union one would assume that, at least, capital has flown in the "right direction". Though, whether this is proof of an efficient allocation of capital also depends on the right size of the capital flows. In Spain and Ireland improved capital market integration and the capital inflows that followed in the course of the monetary union presumably fostered the development of the housing bubble there.[28]

Consequently, even in the monetary union a current account deficit does carry its two faces: Are foreign savings being drawn onto in order to finance growth-enhancing investments, or is the country in question simply living beyond its means, causing a current account deficit through excessive consumption? The latter is more likely to be the case when a serious deterioration of price competitiveness lies at the root of the current account deficits. A sudden

[24] See Allard et al., 2005; Lane, 2006. The present world-wide recession respectively harms German exports more than the exports of their EMU-partners.

[25] For instance, repeated French complaints about the "excessively high" euro exchange rate, which allegedly is responsible for the high unemployment rate in France, were accompanied by demands for a more expansive monetary policy.

[26] The real exchange rates are calculated on the basis of unit labour costs here. See also EU-Commission, 2009.

[27] See Bethge / Ohr, 2007.

[28] See EU-Commission, 2009.

stop of financing options would then bring about intense real economic adjustment processes since the (easier) way through nominal exchange rate adjustments is no longer viable.

Tab. 2:Current account in percent of GDP

	1999	2001	2003	2004	2005	2006	2007	2008
GE	–1.3	0.0	2.0	4.7	5.2	6.1	7.6	7.3
NL	3.8	2.4	5.5	7.5	7.2	8.3	6.6	5.6
AT	–3.2	–1.9	–0.2	0.5	1.1	2.4	3.2	2.8
FR	2.6	1.7	0.4	0.5	–0.9	–1.3	-1.2	-2.8
IT	0.7	–0.1	–1.3	–0.9	–1.6	–2.6	–2.5	-2.8
IE	0.6	–0.6	–0.0	–0.6	–3.5	–4.2	-5.4	-5.0
GR	–3.6	–7.2	–6.4	–5.6	–7.1	-11.1	-14.1	-14.0
ES	–2.9	–3.9	–3.5	–5.3	–7.4	–8.9	-10.1	-10.1
PT	–8.6	–9.9	–6.1	–7.6	–9.5	-10.1	–9.8	-12.1

Data: IMF (2008)

Despite the introduction of the euro bringing on a convergence of inflation development between the member states, the remaining differences are however country-specifically persistent. The results are increasingly diverging price (and labour cost) levels and – as had been feared by the Maastricht critics – shifts in competitiveness between the EMU members. Finally, this persistence of the different developments in the EMU members' price competitiveness being a source of growing external imbalances could lead to centrifugal forces within the monetary union.[29]

3.2 Fiscal Discipline and the Stability and Growth Pact

Another weak point of the monetary union is the insufficient fiscal stability. The required fiscal discipline, upon which was agreed, has not been sufficiently applied. This becomes obvious from the downright unscrupulous way with which the Stability and Growth Pact has been dealt. The fiscal stability criteria were repeatedly not met. Thus, in 2004 the fiscal deficits of six (of the then twelve) member states were far higher than the maximum rate of 3% of GDP prescribed by the pact. In a number of countries this situation lasted up to three to four years without ever coming to the stipulated sanctions against these states (see Fig. 7).

[29] See Goodhart, 2007.

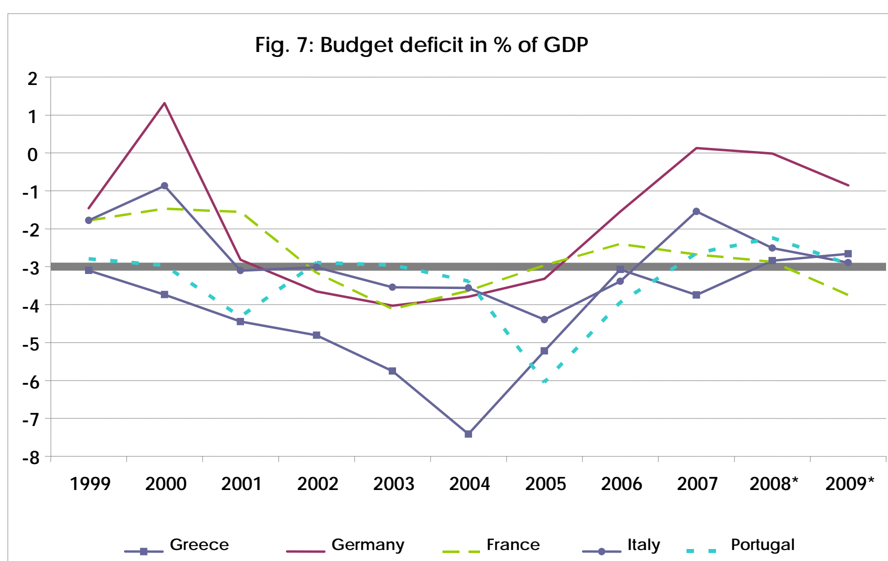


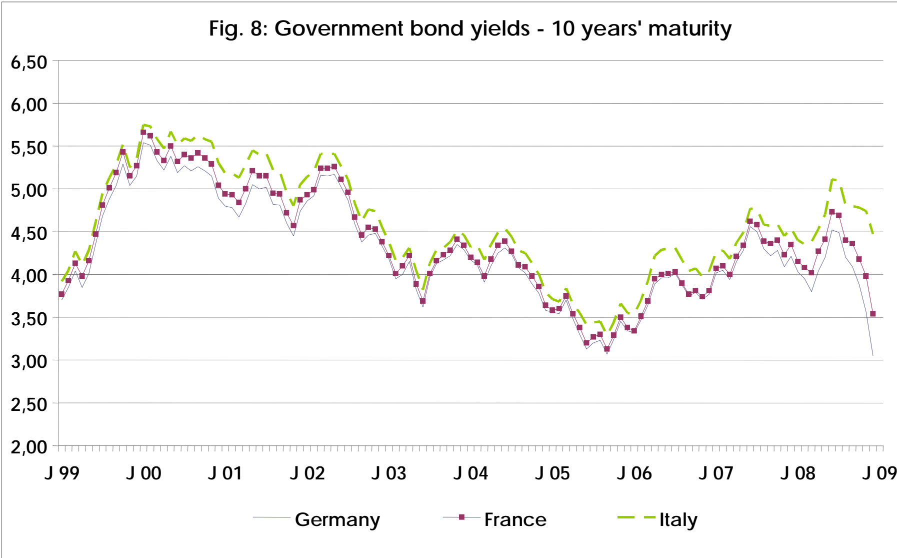
Fig. 7: Budget deficit in % of GDP

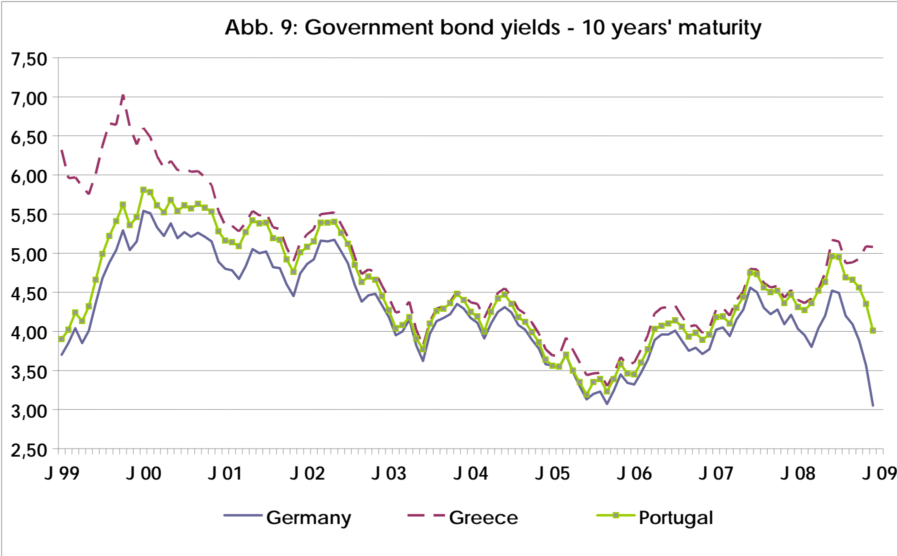
Data: OECD (2009)

Instead, the Stability and Growth Pact was adjusted to be more flexible: Above all the exceptional cases for exceeding the tolerated rate for the fiscal deficit have been extended and, secondly, further broadened in its interpretation. Furthermore, even the timeframe, within which an excessive fiscal deficit has to be corrected, has been made more flexible. In this respect, overcoming the financial crisis and the current global recession is definitely going to be another touchstone for the European Monetary Union and its currency: If past experience is any judge, the Stability and Growth Pact will provide neither the necessary incentives nor sufficient pressure to scale down again the budget deficits caused by the economic stimulus packages to acceptable levels. According to the EU commission's most recent projections national fiscal deficit in 2009 will amount to more than 3% of GDP in seven euro countries; indeed, the forecast for 2010 are fiscal deficits above the 3 % limit in nine countries.

For the rest, the fact that the yields of long term securities, such as government bonds, are currently drifting apart shows that the member countries are regarded by investors as heterogeneous and afflicted with different risks now (see Fig. 8 and 9). The effects of the global financial crisis on the euro countries are various and diverse, thus intensifying the degree of heterogeneity in the euro zone. For example, Greece, Spain and Ireland are still suffering the consequences of their own real estate crisis. Meanwhile, Austria has to pay a considerable risk premium because it is strongly engaged in the East European capital markets, which themselves are now severely affected by the crisis too. In contrast, Germany, heavily dependent on exports, is increasingly affected by the global economic downturn.

While Germany still maintains its role as benchmark, the situation of indebtedness in some of the member states is worsening.





Data: Eurostat (2009)

3.3 Euro, Internal Market and Endogeneity of the Optimum Currency Area

These rather negative developments could however be overcompensated by other – positive – integration effects of the currency union. The question to be answered here is whether the euro has positively influenced intra-EMU trade, direct investments, growth or the overall economic situation in the euro zone.

The predicted increase in the growth of trade within the currency area resulting directly from the introduction of the euro has materialised only to a limited extent. According to the latest research findings[30] the euro's effect on trade between partner countries within the monetary union lies only between 5 and 15 percent, with a similar and concurrent intensification of trade with non euro countries. In most of the member states the share of trade with euro partners as a percentage of the respective country's total trade has remained constant, if not even sunk.[31] Especially in the trade in services there have been no noteworthy increases.

Even direct investments between member countries have (proportionately) increased only slightly. Direct investment inflows from outside the monetary union did indeed increase strongly at first, however so did the outflows out of the union.[32] Indeed, there is little that points to the euro significantly attracting more investors. Nor is there any indication of the hoped-for convergence of prices in the euro zone. Instead, it seems as though price convergence has come to a standstill since the beginning of the monetary union.[33] Price differences result from imperfect competition in the retail sector caused by high transaction costs, strongly nationally segmented retail markets, different product regulations, preferences and the like. The former existence of various currencies was, in contrast, apparently only a marginal impediment to price transparency and price harmonisation. Thus, the expected support of the single market integration through the single currency appears to be small.

Nevertheless, the question remains as to whether, in the meantime, a certain endogeneity of the optimum currency area is indeed emerging. As mentioned above, there is, however, no sufficient evidence of an highly increased intensification of trade and direct investment within the European Monetary Union. Instead unit labour costs and price levels are drifting apart. In most member states the required labour market flexibility has not sufficiently improved.[34]

[30] See Baldwin, 2006.
[31] See Lane, 2006.
[32] See Taylor, 2007.
[33] For what follows see also De Grauwe, 2009.
[34] See Mongelli / Vega, 2006

There is also no obvious trace of the predicted growth effects of the single currency:[35] If one compares the years before the start of the monetary union with those after it, average growth rates in the euro zone remain practically unchanged. But countries that do not belong to the union (such as Japan, Great Britain, Sweden, Denmark, and Canada – but not the USA) were able to achieve higher growth rates in the years following 1999 than before 1999.[36] Furthermore, within the monetary union there are even bigger differences in the growth trends. Besides, even hopes for a higher degree of synchronisation of the business cycles have yet to be fulfilled. Last but not least, the persistent external imbalances militate in favour of the conclusion that an endogeneity of the optimum currency area for the European Monetary Union still cannot be confirmed.[37]

4. Conclusion

Now, if one recalls in mind the main points of criticism on Maastricht, it becomes clear that the early critics have indeed been proven right on quite a few of them:

- The Maastricht convergence criteria do not represent the criteria that would be needed for the ex ante definition of an optimum currency area's boundaries.
- There is virtually no significant trace of an ex post endogeneity of the optimum currency area – that would have compensated the lack of an ex ante proof.
- Fiscal stability is not guaranteed, as is shown in the dealing with the Stability and Growth Pact.[38]
- Different national interests as regards the single European monetary policy are becoming ever more distinct, even though, until now, the ECB has shown itself unperturbed.
- Persistent shifts in competitiveness between the members of the monetary union have built up – as predicted – at the expense of the previously weak currency countries. These shifts are the result of asymmetric developments in the member states which are not compensated by other adjustment mechanisms.

[35] Deutsche Bundesbank, 2008.

[36] See De Grauwe, 2009.

[37] See Arghyrou / Chortareas, 2008.

[38] On the proposal for a more incentive-compatible revision of the Stability and Growth Pact, see Ohr / Schmidt (2006).

- Meanwhile there appear indirect claims for intra-European financial compensation with the idea of a euro bond being brought up for discussion. This euro bond would help EMU members with particularly high budget deficits to finance themselves without having to pay heavily increasing risk premiums. This would naturally go at the expense of the sound countries that – through the euro bond – would have to bear the risks (and the premiums) of the weak partners. Moreover the disciplinary effect of market valuation would be weakened.
- The positive effects on trade, direct investments and growth[39] in the euro zone are small, if at all present.

The risks of the monetary union that had been predicted in the 90ies have therefore materialised in the meantime – even though they have not yet[40] essentially affected the euro's stability. However, the growing economic divergences could eventually lead to tensions between the member countries and put a strain on the ECB's stability oriented policy. Consequently it will become increasingly difficult for the ECB to define an efficient single monetary policy for a group of heterogeneous countries that, for example, have substantially different demands with regard to their current accounts.[41]

The current external shock of the global financial crisis adds another big challenge. On the one hand it looked as though small countries, like Denmark or Iceland (although the latter is not even a member of the EU), would now seek the safety of the monetary union. On the other hand it is now sometimes debated on whether the euro zone countries most affected by the crisis should leave the monetary union and reintroduce their own currency and national monetary policy.

The possibility of an exit from the European Monetary Union is not explicitly laid down in the Maastricht Treaty. But even for the EU as a whole there have been no specifications in this respect. The right to exit the European Union is first mentioned in the constitution draft and then in the Lisbon Treaty. Presumably, these rules can also be applied for the monetary union. Realistically speaking, however, leaving the union would be inefficient even for those countries that have been particularly affected by the crisis, i.e. those with large current account deficits and public debt and which would like to see their currencies devalue.[42] Even if devaluation improved their export chances, the risk premiums would be so high that to keep

[39] See de Grauwe, 2009.
[40] Standing May 2009
[41] See Arghyrou / Chortareas, 2008.
[42] See Eichengreen, 2007.

capitalin the country interest rates would have to rise sharply. Since current national debt is denominated in euro, debt and debt service in a country's own currency would dramatically increase – with it also the danger of illiquidity. Nonetheless, the exit option is being increasingly used as a threat to assert one's own interests in regard to the single monetary policy or to achieve financial support.[43] The bigger and the more heterogeneous the monetary union and the interests within it are, the more relevant the option can become. This is not "really" a problem as long as these threats come from just a few peripheral and small countries. However, it becomes very problematic if through the expansion of the monetary union such countries dominate or if larger countries are affected.

Even though the "no-bail-out" clause enshrined in the Maastricht Treaty bars both the ECB and any other member from taking over a partner country's debt, there is need for solidarity within the monetary union in order keep credibility in the currency area as a whole and thus back up the common currency. If a country were to become insolvent, one could then resort to Art. 122 Lisbon treaty (resp. Art. 100 EU-Treaty), which states that, under particular circumstances[44], the community is allowed to provide an affected member with financial help.

For the first time after ten years in existence, the European Monetary Union is facing a real test. Will it weather the storm or will the risks predicted by the Maastricht critics indeed pose a threat to the stability of the euro and the monetary union? It remains to be seen whether, or rather how, the euro – within the framework of a non-optimal currency area – will overcome the challenges of the global financial and economic crisis without a loss of stability.

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[43] On the importance of the exit option in the EU's decision-making processes see Lechner / Ohr, 2008.

[44] These refer to circumstances which „defy the control of the member state", such as natural disasters; but "with some goodwill", so may the global financial crisis be considered a „particular circumstance".

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The monetary resolutions of „Maastricht“: a danger for Europe (1992)*

1. An economic and monetary union can be seen as a desirable goal in the process of European integration. In key areas, however, the Maastricht agreements do not suffice to achieve this goal adequately.
2. A functioning economic and monetary union requires as a prerequisite the sustained convergence, demonstrated over several years, of the relevant economic structures of the member states. A one-time, more or less incidental fulfilment of individual criteria on a particular date does not constitute evidence of the necessary convergence.
3. The convergence criteria laid down in Maastricht are too soft. Thus, among other things, one should demand as an economic prerequisite for joining the economic and monetary union not just some relative degree of price level stability, but price stability defined in absolute terms.
4. The finale deadline for the achievement of the monetary union (January 1, 1999) will subject the convergence criteria to political pressures within the system. Once the date is reached, there is a danger that especially the inflation criterion and the deficit criterion with regard to “sound public finance” will be watered down politically to avoid discriminating against individual countries.
5. Despite extensive autonomy, the European Central Bank will not achieve price stability in Europe, because, given the different interests of the national decision makers, the ECB lacks sufficient incentive to want stability. The governor’s personal autonomy is not guaranteed and there are no sanctions for those who violate the goal of stability.
6. As a prerequisite for a successful policy of price stability, the European Central Bank should also have competence in setting exchange rates with third currencies. As it is not proposed to transfer this competence to the ECB, there is a danger that its monetary policy will be undermined by political influence on exchange rates in a way that is inconsistent with stability. This holds likewise for the fact that capital controls to third countries are still possible.
7. A consensus still does not exist in Europe as a whole, as it traditionally exists in Germany, that price stability should be considered a priority. But a sustained policy of stability can only be pursued if the central bank, government and people together share such a consensus, because the success of the policy requires, among other things, support from fiscal policy as well as from wage policy at national level.
8. The economically weaker European partner states will face increased competitive pressure under a common currency, and, as a result, they will experience growing unemployment due to lower productivity and competitiveness. This will make high transfer payments in the name of “financial compensation” necessary. As so far no agreements exist concerning the structure of a political union, a system with sufficient democratic legitimacy to regulate this process is lacking.
9. Consequently, there is at present no compelling argument for imposing a monetary union from above on a Europe that is not yet united economically, socially and politically. The achievement of the internal market does not in any way require or call for a common European currency.
10. The overhasty introduction of European monetary union will subject Western Europe to strong economic tensions, which could lead to a political struggle in the foreseeable future and thus endanger the goal of integration.
11. The Maastricht agreements, and not their critics, endanger Europe’s chances of growing together on a peaceful way.

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* Manifesto, published in the “Frankfurter Allgemeine Zeitung (FAZ)” and the “Zeit”, June, 11th, 1992. Signed by 60 professors of economics.

The Euro starts too early (1998)*

1. There is no alternative of European integration. The single currency will be part of it – at least for the core of Europe. However, the Euro comes too early.
2. The consolidation of public budgets has made progress. Nevertheless, it has not advanced enough, especially in large countries such as Italy, France and Germany. The process of consolidation started too late and halfheartedly. In spite of an unusually low level of interest rates, hence reduced costs of debt service, and in spite of numerous examples of creative accounting, the core countries have not succeeded in reducing deficits markedly and sustainably below the 3 per cent reference value. Moreover, the average debt ratio of the member states has not come down since 1991 but has risen by 15 percentage points. As a result, it now exceeds the 60 per cent reference value of the Maastricht treaty by a large margin. This is contrary to the spirit of the treaty.
3. The treaty rightly requires persistence of convergence. To ensure this the so-called "stability pact" has been invented. However, the pact cannot guarantee budgetary discipline. The threat of sanctions is credible, if at all, only if the deficit reference value is violated by one country or very few countries. Given that sanctions are not automatic, it is unlikely that a qualified majority will enforce the pact when a larger number of countries simultaneously violates the limit. The pact cannot ensure the stability of the Euro.
4. Since 1991 the structural problems of Europe have worsened. Unemployment has continued to rise. Notably Germany and France – the driving forces of European integration – are not well prepared to cope with the more rapid structural change and the stiffer competition in a monetary union. The Euro does not solve the unemployment problem of Europe. Given that the exchange rates are no longer available for adjustment, labour markets need to become much more flexible – in Germany as well as elsewhere. An unambiguous change of trend is missing in this respect. If such a trend change is not achieved before the start of monetary union, we will have to expect useless experiments of demand stimulation and above all political pressure on the European Central Bank.
5. The current state of economic affairs is most unsuitable for starting monetary union. An orderly postponement for a couple of years – supplemented by conditions on further progress with respect to budgetary consolidation – has to be seriously considered as a political option. Postponement must not be seen as a political catastrophe. No party can infer from it that the process of integration has come to an end. The persistent success of the Euro is more important than its starting date.
6. An orderly postponement would not be a reason for any country to reduce its efforts at consolidating public budgets. Reducing effort would be a signal that the country either does not make budgetary discipline an objective of its own or that it is unable to take the necessary action. It would be a fundamental error to start monetary union with such a country.
7. Should the attempt of reaching unanimous agreement on an orderly postponement fail, it will be of utmost importance to apply the convergence criteria without any indulgence. Then it must not be declared a taboo that the monetary union starts with a smaller group of countries. On the contrary, with regard to sustainability, the convergence criteria need to be applied as rigorously as possible – as strictly as the treaty permits. Governments who do not take the examination of convergence seriously, undermine the confidence in the actual independence of the European Central Bank and in the stability of the Euro. The start of monetary union would suffer from a heavy burden if the Euro is expected to be weak – inside and outside the monetary union.

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* Manifesto, published in the "Financial Times" and The "Frankfurter Allgemeine Zeitung (FAZ)", February, 9th, 1998. Signed by more than 160 professors of economics.

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