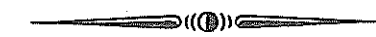
# THE FUTURE OF THE EURO



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# 1

# *Introduction*

## THE FUTURE OF THE EURO AND THE POLITICS OF EMBEDDED CURRENCY AREAS

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THE PURPOSE OF this book is to move beyond a purely economic understanding of the euro crisis and its likely aftermath by emphasizing the political foundations of markets. Our goals in doing so are threefold: first, to develop a holistic understanding of what caused the euro crisis, which incorporates political, ideational, institutional, as well as economic and financial factors; second, to determine how the design flaws of the euro can be fixed for the long term; and third, to define which potential futures lie ahead for Europe's single currency and its users.

The book's core proposition is that one should begin by looking at the "minimal" political and institutional conditions required to make a multi-state currency union work. Only then should one ask whether Europe has those conditions in place or is likely to construct them anytime soon. This introductory chapter provides the overall frame for the book and pulls together the main ideas of the chapters. Drawing together the volume's contributions, we make three interrelated arguments.

First, we maintain that the *euro problem*—the result of three "forgotten unions" quite distinct from monetary union—developed over a much longer period than a focus on the European sovereign debt crisis of 2010–2012 would suggest. We create an analytical framework for the book, which argues that the currency's lack of "embeddedness" in truly supranational European financial, fiscal, and governance institutions was a significant omission that would eventually come to a head. The great crash of 2008 was merely the

catalyst. Those three "forgotten unions" were a financial (and not just banking) union, coherent institutions of supranational economic government (a fiscal union that uses a common debt instrument), and a political union holding comparable democratic legitimacy to the European nation-state.

Second, what we term the *euro experience* shows how the unfinished institutional design of the euro led to overall economic divergence across the Eurozone, rather than the convergence that EU leaders had anticipated at Maastricht in the early 1990s. This divergence quietly altered the distribution of economic and political power within Europe prior to the crisis, with real consequences for how the EU has since responded to that crisis. This section highlights how the economies of the Eurozone's big four states—Germany, France, Italy, and Spain—have each changed since and because of the introduction of the euro, and now struggle to live with the commitments that their common currency necessitates. We highlight how the traditional balance of power among Europe's major states shifted dramatically during the crisis, with Germany gaining in clout, the traditional Franco-German engine of European integration sputtering, and the return of the gap between the core "surplus" countries and peripheral "deficit" countries of the Eurozone. We discuss how existing institutions were tested during the euro crisis, noting how the relationship between national and supranational levels of governance underwent a genuine transformation, including a substantial adjustment in the traditional division of labor between legislative, executive, and judiciary branches of government.

Third, and finally, we examine the *euro future* from three different points of view: first, through the politics of its dominant state but reluctant leader, Germany; second, through the capacity of the European Union to transcend this moment of crisis given its past experience; third, through the lens of the broader geopolitics of the crisis, asking whether the rest of the world will assist the Eurozone by continuing to accept the euro as a global reserve currency. In the concluding chapter, we focus on the return of national politics in the Eurozone and the European Union, as well as future battles that loom on the horizon. We will also propose a typology on how to think about the future of the euro. Following Nassim Taleb's metaphor, we will distinguish the three different "euro swans"—white, grey, and black—that may grace the euro's future in the years to come.[1]

## *From Bright to Blight: A Primer on the History of the Present*

The euro was created in December 1991 when German Chancellor Helmut Kohl and French President François Mitterrand, together with 10 other



European heads of state, all under the authoritative stewardship of European Commission chief Jacques Delors, negotiated a new "Treaty of European Union" in Maastricht, the Netherlands. At the time, the creation of the single currency was welcomed as a visionary act of international statesmanship and a courageous step toward European political unity.[2] The reasoning seemed straightforward. Through the economic convergence that a common currency was presumed to deliver, EU member states would better align their core national competencies and grow into a more politically integrated region, thereby forever relegating any potential military conflict between them to the dustbin of history.[3] With the international state system still trembling from the triple shock of the fall of the Berlin Wall in 1989, the reunification of Germany in 1990, and the imminent collapse of the Soviet Union at the end of 1991, Economic and Monetary Union (EMU) was Europe's imaginative and bold response to the new geopolitical landscape.[4]

EMU would incorporate a recently reunified Germany into an *ever closer union* and tie Berlin's fate to the rest of Europe through a common currency and a common monetary policy. It would also reassure France and the rest of Germany's neighbors that the long dormant "German problem"—a strong German state at the heart of Europe that was both too dynamic and too big for the rest of the continent to keep up with—would never again resurface. These European elites also shared the view that the forces of globalization, mostly evident in rapidly rising international trade and capital flows, meant a substantial hollowing out of the traditional nation-state, and therefore would require an answer at the supranational level.[5] EMU was therefore also seen as the vehicle that would enable Europe to compete as a unified economic bloc with a rising Japan, a nascent North American free trade area, and other emerging giants in Asia and Latin America.[6] Even though it was acknowledged at the time that the single currency's design was incomplete—a monetary union without a fiscal union—Kohl, Mitterrand, and Delors agreed that this would be addressed at some point in the future.[7] That, at least, was the hope.

During the early 1990s, despite the setbacks of the European Monetary System (EMS) crises of 1992–1993, Europe's focus remained firmly on meeting the "convergence criteria" at the heart of Maastricht's road toward EMU: low interest and inflation rates, fiscal deficits under 3 percent of gross domestic product (GDP), and gross national debt levels below 60 percent of GDP. By 1997, despite the implementation of austerity measures to meet these goals, it was clear that only tiny Luxembourg would meet all four criteria. The EU's leaders therefore made the political decision to focus mainly

on the applicants' fiscal deficits, rather than on their overall debt ratios, in order to avoid having a much smaller and predominantly northern euro core to start with. This flexible interpretation and canny massaging of the rules allowed 11 of the then 15 EU members to qualify for EMU membership by 1999. The UK and Denmark opted out, while Sweden decided to wait and then voted against adopting the euro in a referendum in 2003. Greece first needed to make significant progress to improve its fiscal situation, but would join in 2001, just in time for the introduction of euro coins and notes in January 2002.

While the euro initially weakened vis-à-vis the US dollar—the single currency was introduced at $1.17 in January 1999, but steadily depreciated to reach a low of $0.82 during the height of the US "dotcom" boom in October 2000—after January 2002, the euro gradually gained in value, and most Eurozone economies began to grow, in some cases at an unusually fast pace. By the autumn of 2007, the dollar had lost 34 percent of its value vis-à-vis the euro since early 2001. Economists were writing articles and papers about how the dollar's decline would foster the euro's rise.[8] Central banks began to increasingly swap out dollars for euros in their international currency reserves.[9] Supermodels started to insist on contracts denominated in euros rather than dollars.[10] And even the villain in the James Bond movie *Quantum of Solace*, released in 2008, demanded euros as ransom, snidely observing, "the dollar isn't what it once was." France's Gaullist fantasy of a united Europe from the Atlantic to the Urals, finally exercising its own monetary power to counterbalance that of the United States, seemed to be coming to pass. But then, within a very short space of time, the wheels came rather spectacularly off the wagon, and the very existence of the euro was deemed to be at stake.

At the heart of it all was—and at the time of writing still is—a pan-European banking crisis. In short, the funding crisis that had laid waste to Anglo-Saxon "highly leveraged financial institutions" (HLFIs) via the subprime mortgage crisis in the United States only fully hit Europe in mid-2009. At first the damage seemed contained, but then European policymakers committed a series of self-inflicted wounds that would turn an Anglo-American problem into a distinctly European one.

First of all, the European Central Bank (ECB) signaled to the markets in May 2009 that they would singularly not engage in quantitative easing in the manner conducted by the Anglo-Americans, which made markets nervous about the liquidity of their bond holdings.[11] The German government then doubled down on this error in March 2010, telling financial markets that neither the ECB nor Germany would act as the lender of last resort



for the European banking system, since there was no backstop provision in the EU Treaties, in order to avoid moral hazard. Unsurprisingly, given the huge volume of euro-denominated government debt collectively held by the European banking system, yields on such government bonds became more volatile and began to creep up.

Bond spreads widened over the course of 2010 and 2011 as the market repriced the risk of sovereigns with no printing presses facing possibly insolvent banks with multiples of GDP on their balance sheets and no lender of last resort coming to their rescue.[12] Iceland's and Ireland's fates suddenly seemed much more than mere isolated incidents. The crisis had become systemic. Widening spreads accelerated to critical levels when private liquidity to the European banking system effectively dried up in mid-2011 as US money market funds withdrew from interbank funding markets. As a result, the collateral used for short-term borrowing by European banks, euro-denominated sovereign bonds, fell further in value.[13]

HLFIs going bust have the potential to bring down entire economies, hence the concept of "too big too fail." But what Europe had done, almost without noticing, was to build itself a banking system that was "too big to bail" by any one sovereign, including Germany. Only the massive balance sheet and full commitment of the ECB to provide unlimited liquidity can stabilize such a system. Yet, as noted above, then ECB president Jean-Claude Trichet had expressly disavowed that commitment, passing the buck to the Germans, who duly passed it back to the ECB. Then it was passed around the rest of the Eurozone throughout 2010 and 2011 at one crisis summit after the other, pushing yields up higher and higher.

That basic and indispensable commitment was only given reluctantly by Trichet's successor, Mario Draghi. It had three components. First was Draghi's announcement of the long term refinancing operations (LTROs) for the European banking system in December 2011 and again in February 2012, which pushed 1.5 trillion euro at near zero interest rates into Europe's banks. Second was his emphatic and bold promise to do "whatever it takes" ("within our mandate") to save the euro in July 2012. Third was his concomitant policy initiative of "conditional" outright monetary transactions (OMTs), which promised to buy sovereign bonds *in extremis*, in early September 2012.

Consequently, between the autumn of 2009 and the summer of 2012, Europe experienced a "sovereign debt crisis," which is a rather odd name for a crisis of systemic over-lending by European banks. And European governments responded with austerity policies that exacerbated rather than limited the economic slump that followed. At the time of writing, the euro seems to

have survived intact, but only because the private debts of the banking sector were socialized and paid for through draconian cuts in government spending plus, of course, the actions of Mario Draghi at the ECB.[14]

As we enter 2015, financial analysts are bullish again on the euro, pointing out that the global share of central bank reserves held as euros is on the rise again, while sovereign bond yields have fallen to record low levels. The ECB has announced new so-called Targeted LTRO programs aimed at restoring lending to the private sector, made its deposit rates negative in order to push even more money out the door, and launched another bold plan in October 2014 to buy an extra 1 trillion euro in covered bonds and asset-backed securities (ABS) during the last three months of 2014. It seems that the crisis is over. But are we in fact so lucky? Are we back once again to the euro's Bright future after a time of Blight? For even if one believes the banking crisis sketched above has been triaged through the provision of infinite liquidity, if we approach the euro crisis from a focus on the political foundations of markets, we should perhaps not be so sanguine. Perhaps we might conclude that the banking crisis that still lies at the heart of the euro woes was indeed catalytic, but that it was merely one part of a deeper and multifaceted crisis of politics, institutions, and governance that has not at all been resolved.

These interlocking and emergent crises lie in the realm of what the economist Abba Lerner once referred to as "unsolved political problems." He once observed that "economics has gained the title Queen of the Social Sciences by choosing solved political problems as its domain."[15] Economic theories usually start with how the world should be—a model—which presumes that all the relevant political problems have long been solved. All that is left to do, then, is to figure out the most efficient means to get to the end the model prescribes. But such a view of the world assumes away all the politics that in fact make such a world go around. This confusing of the model for the reality it purports to describe lies at the heart of Europe's current condition.

## *The Political Foundations of Markets: Moving from Optimum to Minimum*

There is an old joke about an economist who finds himself trapped on a desert island with only canned food. He quickly assumes the existence of a can opener to solve his predicament. The joke really is not all that funny, but it serves its purpose as a reminder of the limits of economic solutions to what are essentially political problems. As Lerner cautioned, economic theories always start with an idealized version of the world, such as a frictionless market, a



rational investor, a representative agent, or in the case of the euro, an optimal currency area. Economists then measure how much the world deviates from this ideal, and the policy solution that logically follows this is to reform the world to become more like the theory.

Vintage 1999 and more recent economic criticisms of the euro as "not fulfilling the requirements of the theory of optimum currency areas (OCA)" are a telling example of this genre, as is Europe's general reform agenda since the outbreak of its crisis.[16] It is undeniable that Europe never met the requirements of the theory, either in whole or in part. There were never any complete markets with cross-border flexibility in all factors of production to absorb asymmetric shocks. Now, after being slammed by banking and debt crises, the current reform agenda of Europe actually seeks to replicate the economists' approach in reality. Through a singular political commitment to structural reform and improving the region's cost-competitiveness without institutional or financial compensation, the euro's reformers in Brussels, Frankfurt, and Berlin seek to make Europe more like the one portrayed in the theory of optimal currency areas—one with symmetric shock absorbers, super-flexible labor markets, and an operative law of one price across financial markets. In the language of the varieties of capitalism literature, European policy elites are trying to take multiple sets of differentiated institutional complementarities, otherwise known as distinct national economies, and turn them into one set of undifferentiated complementary institutions.[17]

Yet such a view of "what is to be done" rather carelessly assumes away the complicated bargains and distributive politics that make integrated markets and a single currency possible in the first place and assure its sustainability over the long term. Such a view begins with the premise that politics is some kind of noise or friction in an otherwise self-equilibrating system that needs to be eliminated. As a consequence, we need rules, pacts, and treaties to constrain politicians whose policy tools should be delegated to technocrats who can safely ignore the demos and get us closer to that optimal world. This is the recent history and the immediate future of the euro—and it has been less than successful of late.

However, if we shift our focus and start with politics as the fundamental underpinning of the system itself—as constitutive of the system's basic institutional design rather than an aberration to be removed by a suitably qualified technocracy—a political account of the euro must start with a theory of minimums rather than optimums. That is, we need to ask, what are the various institutional and political minima required to make a single currency, encompassing a set of integrated markets across distinct national economies,

work? And what are the politics involved in creating those minimum requirements? These questions bring us to the heart of the book and the contributions of its authors.

## *The Euro Problem: Embedded Currency Areas and Multiple Forgotten Unions*

The book begins with Kathleen McNamara's analysis of the politics of "embedded currency areas" in Chapter 2. McNamara uncovers the minimum institutional and political prerequisites for a stable currency union from an examination of past currency unions. She argues that the euro is notably different from every other successful single currency in history in that it has been fundamentally "disembedded" from the specific social and political institutions that provided a solid and durable foundation for any monetary union in the past. Markets, she argues, need political authority to create stability. The lack of governance will hurt the euro going forward more than its objective shortcomings as an optimum currency area or a set of flexible markets.

The history lessons of previous monetary unions, which McNamara codes on a continuum from "least embedded" to "most embedded," have a lot to say about the Eurozone's current predicament. They suggest that European leaders and their publics will need to channel the historical sociology of Karl Polanyi, rather than the free markets of Friedrich von Hayek, if they want to fix the euro's problems. If it is to succeed in the long term, McNamara believes the Eurozone must be transformed into a truly *embedded* currency area (ECA). The next three chapters build upon McNamara's opening to give us greater clarity concerning the three "forgotten unions" that either directly caused the euro crisis or exacerbated its effects: the "forgotten" financial, economic, and political unions that would constitute a real ECA.

In Chapter 3, Erik Jones views the euro crisis not as a crisis of the euro, but as a crisis of the single market. Jones argues that when Europe's political leaders pushed for capital market integration and the liberalization of cross-border banking in the late 1980s and early 1990s, they failed to build common institutions to ensure financial stability. Instead, they held on to *national* institutions for banking regulation, supervision, resolution, and insurance. These were too small and too fragmented to guard against the risks generated by the behemoth pan-European banks and insurance firms that emerged in the single market's integrated financial space. Jones explains why this failure to construct common institutions to safeguard against the risks generated by integrated pan-European financial markets was a big mistake. His goal is not



to argue against the view that monetary integration contributed to Europe's problems. Rather, his goal is to show that the absence of any financial union was sufficient, in and of itself, to bring some sort of crisis about. If Europe's policymakers refuse to rectify this situation, Jones fears, they will have to relive the experience.

Nicolas Jabko, in Chapter 4, shows us how the euro crisis is a product not only of Jones's forgotten financial union, but also of a forgotten union of economic governance, parallel to the one lacking in financial markets. Jabko observes that because monetary policy was unified at the EU level, while most other economic policy powers remained in the hands of national governments, an unforeseen conflict between national sovereignty and a new conception of sovereignty that called for its exercise at the European level developed below the radar since the euro's introduction. This conflict became fully evident only after 2009 with the deepening of the Eurozone crisis, but in reality it was, like Jones's forgotten financial union, generated by long-standing "unsolved political problems." For Jabko, the Eurozone crisis is then a crisis of economic governance in a situation of divided sovereignty that compounds the systemic risks generated by the inability to properly regulate financial markets, which Jones highlights. The crisis showed us that while the institutional status quo had become untenable, there was no magic formula to strengthen economic and fiscal governance without further encroaching on national sovereignty, which politicians solely accountable to the national level were simply unwilling to do.

Jabko notes how since the summer of 2011, under the intense pressure of yield spikes and multiple downgrades, member states have de facto moved toward shifting more sovereign powers to the EU level. They have adopted treaty revisions that *could* ultimately reshape the landscape of economic governance, such as the creation of the European Stability Mechanism (ESM) and the "Fiscal Pact" (formally known as the Treaty on Stability, Coordination and Governance). In late 2013, member states endorsed the principles of a single banking supervisory and resolution mechanism, a "pact for growth and jobs," and a "specific and time-bound road map for achieving a genuine economic and monetary union."[18] Yet these steps are, we argue, still too conditional, and in the case of the banking union's single resolution mechanism, still very much contested. Building upon Jones's conclusion, Jabko warns that the crisis will not fully abate as long as the credibility of collective economic governance is in doubt. The solution to that lack of credibility is a further deepening and embedding of political institutions as part of a move toward stronger EU economic governance. But whether that will actually happen is

once again likely to remain an "unsolved political problem" in the foreseeable future.

If the forgotten financial and economic governance unions highlighted by Jones and Jabko were the lagged antecedents of the crisis—the accidents waiting to happen—as well as the necessary components of an ECA, then for Vivien Schmidt in Chapter 5, the euro crisis is first and foremost a *political* crisis that is a direct consequence of these hidden fragilities. In particular, she highlights the negative impact on European democracy of the policies proposed and implemented to solve the crisis. These policies—budgetary austerity, wage compression, and a drive for exports—have, Schmidt argues, exacerbated long-standing problems with regard not only to the EU's democratic legitimacy but also to European solidarity.

Democratic legitimacy has suffered not only because Eurozone policies have failed to produce good outcomes, but also because EU citizens have less say than ever over those policies. Indeed, the excessively "intergovernmental" processes of Eurozone crisis governance, in which the ECB acts, the member state leaders in the European Council call the shots, the European Parliament is largely ignored, and the European Commission serves as a secretariat, have unbalanced the EU's long-standing "democratic" settlement in which all three institutions equally pulled their weight. Schmidt further shows us how European democracy suffers a deep crisis of legitimacy that stems from these EU crisis resolution policies. That is, they undercut EU institutions' "output" legitimacy (because of their harmful effects on economic growth and social welfare), they undermine those same institutions' "input" legitimacy (because of their negative effects on citizen participation and representation), and they weaken "throughput" legitimacy (because of rule-making and rule-following that lack efficacy, accountability, transparency, and access).

Taken together, these four chapters demonstrate that the euro crisis is not subject to a simple and singular crisis narrative. It is simultaneously an emergent crisis of finance, governance, legitimacy, and an overarching lack of institutional embeddedness. Overcoming any one crisis is a challenge. The odds against overcoming these obstacles simultaneously and building a real ECA is reason enough to keep some doubts about the euro's future.

## *The Euro Experience: Mind the Gap*

The second section of the book turns from the antecedents and generators of these crises to the actual agents key to resolving them. These are not, in our opinion, the supranational institutions in Brussels. Rather, they are the four



main economic and political players of the Eurozone: Germany, France, Italy, and Spain. In this section of the book we examine how these states differentially experienced both the introduction of the euro as well as the decade that followed, which culminated in the euro crisis. Here we investigate whether the euro game has been worth the candle for these countries, how their economies' intermeshing through the euro helped catalyze the crisis in each country, and why they experienced the same shocks so differently.

Collectively the chapters of Section II argue that once economic growth had returned after the 1992–1993 collapse of the EMS and subsequent recession, northern European capital—in search of higher yields—increasingly flowed into southern European markets in anticipation of the formal introduction of the euro in 1999. Financial market participants implicitly assumed that the approaching adoption of the euro in those countries was a de facto guarantee against any inflation or devaluation, which shaved off most of the existing national risk premiums that had prevailed on Mediterranean (and peripheral) country bonds.[19] The initial result of these financial flows was rapid interest rate convergence and a consequent flooding of local bank funding markets, which held as long as economic times were relatively good, between 1998 and 2008, all of which seemed to vindicate the view that the euro had brought about deeper economic integration in the Eurozone. But rather than leading toward convergence, as anyone just focusing on EMU sovereign bond spreads would have discerned, this process had actually resulted in unsustainably large intra-European balance of payments disequilibria between Germany and everyone else, already visible by 2005.

Unintentionally but consequentially, EMU helped to bring about in reality pre-existing popular perceptions of a gap between a seemingly financially more orthodox northern "core" of "surplus countries" that mainly saved, invested, produced, and exported, and a debt-laden southern "periphery" of "deficit countries" that predominantly borrowed, consumed, and imported. This economic divergence, not the expected convergence of the Treaty of Maastricht, made possible by the same institutional design flaws already noted, allowed capital to flow ungoverned across EMU borders. When these capital flows suffered a sudden stop in 2010 as markets grew wary and banking liquidity dried up, the consequence for the periphery was the sudden realization that by joining the euro they had given up their two main national shock absorbers—devaluation and inflation—for a few points less in interest. This left them with "deflation" (or internal devaluation) as the only option on the table, regardless of its effectiveness.[20]

In the absence of any solidarity mechanism at the EU level—where the North would inflate while the South would deflate, or fiscal transfers from North to South to ease the financial blow—the whole burden of adjustment would fall onto the periphery countries via austerity, leaving the core countries Scot-free. As Vivien Schmidt has noted already, the sovereign debt crisis thereby reawakened old political divisions on the European Continent that the euro was actually introduced to put to rest once and for all.

## *The Reluctant Leader, the Middle Child, and the Troubled South*

Abraham Newman, in Chapter 6, demonstrates how the euro crisis has underscored the critical, and unenviable, role that Germany plays in Europe's regional architecture. For Newman, the German government has persistently pushed a policy response that is motivated by a deep concern to avoid moral hazard by other member states, while at the same time doing what needs to be done to stop the situation from becoming critical. This has resulted in a reluctance to fund or favor quick and forceful commitments to regional bailouts or strong interventions by the ECB.

Germany, it should be emphasized, has not been paralyzed in the face of the crisis. As Newman notes, from a pending Greek sovereign default in May 2010 to the Spanish banking crisis in the summer of 2012, Germany has actively engaged on all fronts and has been the most important member of the resolution team. But in these efforts, Germany has played the role of reluctant leader—cautious and circumscribed—which is a caution that has not been without risk, as this halting response has inflated the costs and duration of the crisis by sowing the seeds of market doubt and sparking wider fears of contagion. By always stressing what Newman terms the "moral hazard frame for policy" over other alternative frames that would legitimate a more aggressive response, Germany has managed to both help resolve and help exacerbate the crisis. Given this, it is important to understand why alternative policy frames underscoring either the risks to German exports and growth, or the uncertainties of contagion to Germany (and the rest of Europe), were ultimately rejected by Berlin.

Newman's historical explanation of Germany's crisis behavior focuses on the costs of reunification in the minds of German voters (and as perceived by German politicians) plus the timing of the German economic recovery of the mid-2000s relative to the timing of the euro crisis. These factors, Newman argues, set in motion a set of political dynamics that favored the selection of the moral hazard response over other possible alternatives. In particular, Newman notes how structural reforms enacted in response to the post-reunification economic malaise, as well as the large fiscal transfers from West to East resulting from reunification, seriously undermined any solidarity impulses within the German electorate.



In Chapter 7, Mark Vail builds upon Newman's work by analyzing the politics of France through the frame of its role as Europe's "middle child," with a particular emphasis on the contradictions of its position as a European leader and anchor of EMU despite its relative economic weakness. Vail argues that the competing allures of statism and liberalism in French leaders' views of governance, France's vacillating commitments to Keynesianism and austerity in policy, as well as France's core but increasingly problematic partnership with Germany, have generated a deeply fraught and inconsistent set of trajectories in its financial and economic policy, both domestically and at the European level.

Vail supports his central claim through a careful analysis of the political debates surrounding EMU in the late 1990s, paired with the debates surrounding the European financial and sovereign debt crisis after 2007. In each of these instances, Vail sees French policy guided by commanding but often contradictory political-economic imperatives: French economic autonomy and the desire for political leadership within Europe, the preservation of its historic partnership with Germany as an avenue of influence in the European Union, while protecting and preserving its cherished "statist-liberal" political-economic model. He concludes by suggesting that this balancing strategy has become even less feasible since the euro crisis, while France's growing ineffectiveness at articulating an alternative vision of European economic policy has reduced the chances of a less austere future for the Eurozone as a whole.

Jonathan Hopkin brings this section to a close in Chapter 8 by focusing on the two "troubled" southern European economies whose actions matter most for the future of the euro: Italy and Spain. Hopkin argues that the fate of the euro really hangs on the outcome of the crisis in the southern European democracies, and argues that the social and political dynamics behind the crisis are ill understood. Hopkin's chapter moves beyond the standard narrative of debtor and creditor nations, examining the political and distributional consequences of monetary union within the two largest southern member states.

Rejecting the conventional wisdom of "insiders" (trade unions) benefiting from excessive wages driven up by North-South capital flows, Hopkin shows us

empirically that the euro brought big gains to the "sheltered" sectors of these economies—construction, retail, and parts of the public sector—while manufacturing workers actually saw their real wages stagnate. But the policies imposed on the South in response to the debt crisis have come down especially hard on unionized workers and other lower income groups, particularly the young, while protecting politically powerful and protected sectors that gained during the boom years and are able to externalize the costs of adjustment onto others.

According to Hopkin, despite these distributional failings, southern Europeans have shown remarkable resilience in the face of these economic and political challenges and remain largely committed to euro membership. However, he fears that the imposition of multi-year programs of "internal devaluation" constitutes a major natural experiment with very high stakes. It counts on southern European citizens to maintain an unwavering commitment to the euro to justify years of sacrifice with no seeming end in sight. Elections held since the euro crisis began have brought major transformations to what were relatively settled patterns of citizen representation and party competition. Hopkin points to the sharp decline in pro-European sentiment and the tenuous grip on government power of pro-European political forces across all southern countries since the crisis, and cautions that Europe's southern periphery's commitment to the euro will be tested to the limit in the coming years.

## *The Euro Future: The Return of National Politics, Muddling Through, or Euro Federalism?*

What can our evaluation of the "euro problem" and the "euro experience" tell us about the "euro future"? The final section of this book grapples with the critical questions raised earlier: how Europe will deal with its new "German problem" going forward, whether the missing unions can be built into a functional ECA, and which international monetary future awaits the euro—either as a subordinate part of a still dollar-centric global monetary system, or as an integral and central part of a multi-polar international currency universe.

Wade Jacoby's Chapter 9 focuses once again on Germany, but from a different angle than Abraham Newman's analysis in Chapter 6. As Berlin will arguably call the main shots in the euro's evolving institutional design, Jacoby considers both the "timing of politics" and the "politics of timing" behind Germany's policy response to the euro crisis. In regard to the "timing of politics," while German policymakers accept the need to intervene in the sovereign bond markets of other Eurozone members and to secure much deeper integration of governing competencies in general to avoid future crises, they want to pick the optimal time of intervention to maximize the efforts of private actors and to deter public and private behavior that might require more bailouts in the future (here, echoing Newman's moral hazard policy frame). If their central focus is on moral hazard, then their aim is that their intervention should come at the "right" time.



German leaders, however, also face a second and largely separate concern about the "politics of timing." Understandably, German elites feel they cannot launch such very large interventions until they have properly prepared their voters. Given these considerations, they have tended to propose rescue packages both later and smaller than needed to stop the dynamics that were undermining confidence in the euro. Yet each time Germany's elected officials have sold a bailout of a certain envisioned size to their voters, or have argued for even more devolved sovereignty to the EU level, the problem has grown such that the proposed solution is now insufficient to the task. These two problems combine to form a serious dilemma for German politicians going forward. If one focuses primarily on the timing of politics, then patience is a virtue, and elites should wait and minimize future moral hazard concerns. If one focuses primarily on the politics of timing, however, then patience is a vice, as windows of opportunity for stemming the crisis slam shut, one after another. The result is therefore often too little, too late, and too timidly delivered.

In Chapter 10, Craig Parsons and Matthias Matthijs problematize the commonly held view in Brussels that the crisis is a great opportunity for reform and therefore a good thing because "European integration always moves forward through crisis."[21] They aim to expose this view as a persistent and even dangerous popular myth by answering two sets of questions. First, is this view historically correct? Have past major advances in European integration actually tended to follow directly from crises? Second, they examine whether this has been the path actually taken during the Eurozone sovereign debt crisis and to what extent it makes sense to say that the EU has "moved forward" as a consequence of the euro crisis.

Parsons and Matthijs review the historical record of European integration since the early 1950s and answer the first question with a negative. While crisis language has been very common across EU history, no major step in the EU's institutional development responded in any clear way to a widely perceived need for policy changes to solve serious and imminent problems. To

the contrary, they argue, the major steps that led to today's EU followed from an ongoing organizational project that advanced despite major contestation among elites (though not publics) about its necessity or even desirability. Their answer to the second question also lies in the negative, noting that while the EU definitely has suffered its first "real" crisis beginning in 2009, they still see Europe's response as reactive, slow, ad hoc, and minimalist.

Nonetheless, they do admit that in some ways the EU has perhaps made itself somewhat better able to respond to similar crises in the future, as per Nicolas Jabko's analysis in Chapter 4, but still has not actually addressed the underlying vulnerabilities noted in the first part of the book in a truly fundamental way. In the view of Parsons and Matthijs, successful projects of reform in huge political organizations rarely, if ever, arise as technically necessary responses to already apparent crises. In such moments, bold ideas are needed since only a positive vision of new European goals will allow the EU to recapture a sense of forward movement. However, in Europe's austere times, such big ideas are mainly conspicuous by their absence.

Finally, Eric Helleiner adds the international political economy dimension to this analysis in Chapter 11. He argues that the future of the euro must be viewed through a lens that focuses not just on intra-European politics but on the international monetary system as a whole. Helleiner argues that for many Europeans, part of the political appeal of the euro has long been that it might serve as a challenge to the dollar-dominated international monetary system. European frustrations over the trajectory of the dollar's value and US policy choices served as a catalyst for strengthening regional monetary cooperation at various moments since the early 1970s. During the 2007–2008 global financial crisis, these European aspirations for the euro's international role came to the surface once again, when many analysts predicted that the US-centered financial upheaval might boost the euro's international role.

Given this context, Helleiner places the euro crisis, and the euro's future, within the ambit of two developments post-2008 that are of great relevance to charting any potential future of the euro. On the one hand, the dollar has shown surprising resilience in the face of the global financial crisis, and effortlessly remains the reserve currency of choice globally. On the other hand, the rise of China's monetary power, primarily linked to its position as the world's creditor, is bound to complicate the dynamics behind the dollar-centric international monetary system.

Helleiner sees these two consequences of the financial crisis as humbling for those Europeans who harbored great aspirations for the euro's future global role. Yet at the same time, they may serve to boost the political



prospects for the euro over the longer term. The desire to challenge US monetary power may bolster European backing for reforms that take regional monetary cooperation to the next level. And Chinese policymakers may well help by keeping up their enthusiastic support for the euro, despite the potential for future crises, based on their own geo-strategic goals.

## *Staying Relevant and Informing Future Policy*

Our conclusion to this volume is rather unusual. Rather than simply reiterating all the arguments in short form, we try to tease out the observable implications of each of these sets of arguments for the future of the euro going forward and try to make predictions on this basis.

To retain any claim to relevance this time around, we feel it is incumbent upon scholars who have made their careers talking about Europe to say something about this crisis before it is fully over, no matter what current LTRO-compressed financial markets seem to believe. While there is considerable risk in doing so, we feel that our collective skill set is broad and deep enough to allow us to say something that can anticipate likely outcomes while making a contribution to scholarship that is empirically sound, theoretically informed, and politically relevant. Or that at least is our hope. As usual, time shall be the judge. But we leave that task for the conclusion.

# *Notes*

## CHAPTER 1

1. Taleb 2010; Blyth 2009; and Matthijs 2012b.
2. See Gilbert 2012, chapter 7, pp. 143–171; Calleo 2011; and Parsons 2003, chapter 7.
3. For earlier "functionalist" thinking on European integration, see Haas 1968.
4. Calleo 2003.
5. Milward 2000.
6. Calleo 2003, chapter 12.
7. Marsh 2011, pp. 153–155.
8. See, for example, Eichengreen, 2005.
9. As Eric Helleiner points out in Chapter 11 of this volume, the share of the euro in non-industrial countries' reserves had risen from 19 percent since the euro's establishment to 30 percent in 2008, while the dollar's share had fallen from 70 percent to 60 percent.
10. Bloomberg News 2007.
11. Trichet 2009.
12. Blyth 2014a.
13. Shin 2012.
14. Blyth 2013a, chapter 3.
15. Lerner 1972, p. 259.
16. See, for example, Bayoumi and Eichengreen 1993; Feldstein 1997; Frankel and Rose 1997, 1998.
17. See Hall and Soskice 2001; and Hall 2014.
18. Van Rompuy et al. 2012.
19. A European Commission directive in 2001 that mandated all euro denominated debt be treated equally as (de facto AAA) collateral in repo transactions simply turbocharged this process further.

20. Matthijs 2014b.
21. This view is dominant in both EU scholarly as well as policy elite circles. Recent scholarly examples: Gross 2011; and Schmitter 2012. Examples of policymakers: Merkel 2010a; and Van Rompuy 2011. See Chapter 10 in this volume.

## CHAPTER 2

1. Most prominently, Feldstein 1997.
2. Reviews of OCA theory include Mongelli 2002.
3. Mundell 1961.
4. I am using monetary union, currency union, and single currency somewhat interchangeably to mean a geographic area with one monetary policy and one currency or irrevocably locked exchange rates.
5. Friedman 1953.
6. Mundell 1961.
7. McKinnon 1963.
8. Kenen 1969.
9. Kirshner, ed. 2003; Helleiner 2008.
10. Polanyi 1957. See also Berman 2006; Blyth 2002.
11. A subtle analysis of the relationship between Polanyi's ideas, monetary law, and EU law is found in Everson and Joerges 2012.
12. Abdelal, Blyth, and Parsons 2010.
13. Erik Jones's Chapter 3 in this volume further elaborates on the role of central banks in monetary unions.
14. See Nicolas Jabko's Chapter 4 in this volume for a full explanation of the importance of fiscal union.
15. The importance of political union and democratic legitimacy is explored in Vivien Schmidt's Chapter 5 in this volume.
16. On the European experience, see Tilly, ed. 1975; Evans, Rueschemeyer, and Skocpol, eds. 1985. For the US experience, Burnham 1970; Stephen Skowronek 1982; and Bensel 1991.
17. Poggi 1978, p. 93.
18. Tilly 1985.
19. McNamara 2002.
20. McNamara 2002; McNamara 2003; and McNamara 2011.
21. McNamara 2011.
22. On the Soviet case, see Woodruff 1999.
23. This section draws on McNamara 2002, as well as on McNamara 2011.
24. See Bensel 1991.
25. Binder and Spindel 2013.
26. Henning and Kessler 2012.
27. Mattli 1999.



28. Holtfrerich 1993.
29. Foreman-Peck 2006.
30. Flandreau 2003.
31. Flandreau 2003.
32. The classical gold standard of the nineteenth century has some similarities t the Eurozone in that the fixed rate commitment meant that adjustments ha to be made through other policy instruments than the exchange rate. Howeve as an intergovernmental agreement, it did not have aspirations toward any so of collective decision-making such as that implied by a currency union. For more complete treatment of the gold standard in terms of its lessons for EMU see Matthijs 2014b.
33. Spruyt 1996; Anderson 1983; Weber 1976.
34. Flandreau 2000; Eric Helleiner 2003; Einaudi 2001.
35. Eichengreen 2008.
36. Eichengreen 2008.
37. Reinhart and Rogoff 2009.
38. The Eurozone does not match all the criteria of the OCA models according t Eichengreen and others; see Eichengreen 1991. However, recent analysis show more mobility in the factors of production among the core countries of Europ as the single market has deepened, advances in social welfare portability acro the EU has allowed for more labor mobility, and financial integration has take off. See Rose 2008.
39. On how the ideational underpinnings of the ECB created these constraints, se McNamara 1998.
40. See Erik Jones's contribution to this volume (Chapter 3) for a full accounting the role of the ECB in the euro crisis.
41. Fiscal union and "economic government" in the EU are further explored i Nicolas Jabko's Chapter 4 in this volume.
42. See Matthijs 2014b as well as Chapter 8 by Jonathan Hopkin in this volume.

## CHAPTER 3

1. Jones 2014.
2. Pelkmans 1987; Schreiber 1991.
3. Vipond 1991.
4. European Central Bank 1999, pp. 15–16.
5. Duffy 2012.
6. Annual Macroeconomic (AMECO) database, European Commission.
7. International Monetary Fund 2011, p. 15; Vandevyvere and Zenthoefer, pp. 12, 1
8. Obstfeld 2013.
9. White 2012, p. 19.
10. Gangahar and Jones 2007.