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The Introduction of the Euro: Who Warned, and Why?

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(Work in progress; first and very preliminary version.
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Abstract

When the Euro crisis began in the wake of the worldwide financial crisis many journalists, politicians and economists said that they had warned about the introduction of the Euro in 1999. Therefore, they felt that the development had them proved right. In this paper, the question is analyzed whether this conviction is justified.

It is indeed true that there were many warnings. But it seems to be the case that the real problems were quite different from the ones discussed before 1999. So the alerters seem, at most, to be right for the wrong reasons.

The paper investigates the question on two levels:

1) It analyses the development of the textbook by DE GRAUWE from the 1st to the current (12th) edition a
2) It looks at some contributions from German and international economists (here: the authors of two manifestos in Germany against the Euro and the debate in the *Journal of Economic Perspectives* between CHARLES WYPLOSZ and MARTIN FELDSTEIN)

All in all, the paper makes the case that it is not only important that warnings were issued but also to analyze whether these warnings were actually justified with regard to contents.

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1. Introduction

> "Economists are often criticized because they are very bad at predicting crises and very good at explaining afterwards why these crises were inevitable. However, if there is one area where this criticism does not apply, it is in the economics of monetary union. In the 1980s and early 1990s, when the European leaders were discussing the plans for a monetary union in Europe, economists, including the present author, warned that this would be a risky undertaking, mainly because it would be a monetary union lacking a budgetary union. The European leaders, who were driven by political motives in pushing for monetary union, brushed this criticism aside and created an incomplete monetary union that, because of its incompleteness, would be fragile. The economists' prediction has now turned out to be vindicated. This has been especially true sind the emergence of the second Greek debt crisis in 2015, when the possibility of a Greek exit from the Eurozone was openly discussed." (DE GRAUWE 2018, p. IX).

This paragraph stands at the beginning of the latest edition of DE GRAUWE's famous textbook on the economics of monetary union – and it reflects the feelings of many economists that the profession had hinted to the problematic aspects of the Euro and the organisation of the European monetary union.

But are these feelings really justified? There is no doubt that before the introduction of the Euro many warnings have been issued. But what were these warnings about? Did they hint at the crucial points that became dangerous problems during the crisis and led to the Euro's near collapse?

This paper will make a first and quite preliminary case that the contents of the warnings that were given before and during the first years of the monetary union did not have much in common. It will be shown that many economists' sceptical outlooks on the monetary union did not point to the problems that became virulent during the crisis. This verdict also applies, as will be seen, to PAUL DE GRAUWE himself, despite his brilliant analysis of the problem of default in a monetary union and the speculative attacks against governments. For this analysis is also a telling example of "explaining afterwards" instead of "predicting crisis".

The paper is structured as follows: in section 2, the most important problems of the European monetary union as they became apparent during the crisis are briefly sketched. Sections 3 and 4 look then at the warnings that were issued before the start of the monetary union. Section 3 analyses the development of the textbook by DE GRAUWE from the 1st to the current (12th) edition and shows that the problems that were discussed before and during the first years of the monetary union were often different from the ones that were important in the crisis. Section 4 looks, first, at the manifestos against the Euro that were published in Germany in 1992 and 1998 and analyses the debate between Charles Wyplosz and Martin Feldstein in the Journal of Economic Perspectives in 1997. It will be shown that the points that were prominent in these debates were not that important in the Euro crisis whereas other problems that were mentioned only as secondary objects at best became central in the course of the crisis. In section 5, some conclusions are drawn.

This paper is just a first start and offers only some tentative conclusions that are, so far, based on a very selective literature review. But it hopes to raise some interesting points that are to be deepened in future versions.

2. The Construction Problems of the Euro zone

Which problems were actually relevant when the Euro crisis broke out? I want to sketch this only briefly as these problems were already analysed in very many publications.

- Fiscal profligacy?

The fiscal proflicagy many politicians named as the main culprit was relevant only for one country, Greece. And even here one could say that the amount of government debt would not have been much of a problem if Greece had not been a member of the monetary union. Countries with their own currency did not have the problems the European crisis countries had. On the other hand, Spain was one of the five crisis countries (besides Portugal, Italy, Ireland and Greece) although it had – until 2012 – a debt ratio lower than Germany.

- Diverging competitiveness and differing inflation rates

From the start of the monetary union the competitive positions of the member countries started to diverge. Some countries, especially Germany, had continuous real depreciations vis-à-vis the other countries. A main reason for that were diverging developments of the unit labour costs – they stayed constant or even declined in Germany and rose faster in other countries. As the growth rate of unit labour cost is one of the main determinants of inflation, inflation rates differed: they were below 2% in Germany and above 2% in the southern countries which led to an average inflation in the Eurozone of about 2% but a divergence of competitive positions; that, in turn, contributed to the buildup of large current account balances.

- Original sin and missing lender of last resort

As PAUL DE GRAUWE analysed in the course of the Euro crisis, financial markets were able to force default on member countries they distrust for some reason. The countries hit by this speculation had large current account deficits and negative net international investment positions, sometimes (e.g. Ireland, Spain, Portugal and Greece) 100% of GDP and more. When financial investors started to sell government bonds of these countries it turned out that the Euro has to be regarded as similar to a foreign currency the government has no control of so that the analysis of „original sin“ (EICHENGREEN/HAUSMAN/PANIZZA 2007) which was seen as a problem mainly for developing countries and emerging markets applied also to the countries of the Eurozone. Furthermore, the national central banks could not act as lenders of last resort and end the speculation;finally, with MARIO DRAGHI’s speech in July 2012, the ECB accepted this task – which was not seen as a regular task of the ECB before the crisis –, at least reluctantly and with some caveats.

- Missing fiscal capacity on the European level

The construction of the monetary union did not provide for fiscal policy action on the European level. There was neither a European budget that could alleviate local/national shocks to aggregate demand nor European-wide automatic stabilizers – e.g. a European unemployment insurance – that would dampen boom-bust cycles. The countries can only rely on national fiscal policy which underlie severe restrictions. This situation makes it possible that the Euro crisis can come up again as the financial investors cannot be sure that the ECB will always fulfil the role as lender of last resort.

3. Paul De Grauwe's *Economics of Monetary Union*

The first edition of De Grauwe's textbook was published in 1992 and had the title "The Economics of Monetary Integration". With the 4th edition, published in 2000, the title changed to „Economics of Monetary Union". The following table shows the publication dates of the different editions.

edition	Year of publication
1st	1992
2nd	1994
3rd	1998
4th	2000
5th	2003
6th	2005
7th	2007
8th	2009
9th	2012
10th	2014
11th	2016
12th	2018

The basic structure of the book stayed basically the same: the first part treats the costs and benefits of a monetary union, the second part several aspects of monetary integration (or monetary union).

The first part of the textbook did not change much in the different editions: It discusses the pros and cons of the theory of optimum currency areas, assesses that according to the conventional criteria the member countries do not form an OCA but that there may be some kind of endogeneity of the criteria. Starting with the 5th edition, also the possibility of monetary unions in other world regions (Latin America, Asia [from the 6th edition] and Africa [from the 7th edition]) was discussed.

The more interesting part for the topic of this paper is the second part of the book. Here De Grauwe discusses the problems of incomplete monetary unions, including possible measure to complete them, the transition to the EMU and the convergence criteria, the structure and policy of the ECB and fiscal policy in the Eurozone. Looking at these chapters in the various editions one can see how the crisis has changed the contents of them.

3.1 The problems of an incomplete monetary union

The focus of the chapter(s) about incomplete monetary unions has changed dramatically in the course of the Euro crisis. Up to the 8th edition this chapter is mainly concerned with the fragility of fixed exchange rate systems. DE GRAUWE discusses the credibility problems of fixed exchange rate systems and the speculative attacks that can occur: his prime example is of course the collapse of the European Monetary System in 1992 and he states:

> "What we learn from this episode of fixing exchange rates in Europe is that this can only work as a transitory device towards full monetary union. As a permanent monetary regime a fixed exchange rate system is too fragile. Countries, therefore, have the choice between more flexible exchange rate arrangements or a full monetary union." (DE GRAUWE 2009, p. 142)

There is, up to the 8th edition, no further discussion of completing the monetary union in terms of the lender-of-last-resort function of the central bank on the market for government bonds nor concerning the introduction of common bonds.

That changes drastically with the publication of the 9th edition. Now, the incompleteness of the monetary union refers not only to the abolition of the fixed exchange rate system but – due to the experiences in the Euro crisis – also takes into account that speculative crises can still occur, namely on the market for government bonds. The mechanisms and the possibility of self-fulfilling prophecies and multiple equilibriums are practically the same as in a fixed exchange rate system but that was not foreseen before it actually happened. We will come back to that in section 3.4.

3.2 The problem of diverging competitiveness

The problem that the competitive positions of the members of the Eurozone could diverge was not treated until the divergence became clearly visible. This divergence came from persistently diverging inflation rates which are in turn the result of different developments of unit labour costs in the member states. DE GRAUWE – and most other authors – did not treat this problem from the start. There have been warnings that a smooth functioning of the European Monetary Union demands an appropriate wage policy (e.g. FLASSBECK 1997): the wage increase in each member country should be equal to the increase in productivity plus the target inflation rate (2%) so that unit labour cost would increase by 2% in each member country: that would fulfil an important condition for similar developments of inflation in each country and also preclude gains and losses in price-related competitiveness. Some authors (e.g. SCHÜRFELD 1998) did not even think that a competition for the lowest wages could be a relevant danger; should wage restraint happen, then it will lead to higher employment.[1]

DE GRAUWE deals with the problem for the first time in the 7th edition, published in 2007. Here, he calls "the extent to which the competitive positions of the member countries have diverged as "[o]ne of the surprises of the functioning of that monetary union" (DE GRAUWE 2007, p. 32).

[1] „Die Überlegungen verdeutlichen, daß die Argumentation für einen Lohnsenkungswettbewerb in der Europäischen Union einer kritischen Prüfung nicht standhält. Es wurde gezeigt, daß eine Lohnzurückhaltung (relative Lohnsenkung) durchaus Beschäftigung schaffen kann und nicht zu dem Szenario eines degenerativen Lohnsenkungswettbewerbs führen wird. Vor allem die Berücksichtigung institutioneller Gegebenheiten führt zu dem Schluß, daß eine gefürchtete Abwärtsspirale von Löhnen und Preisen, die letztlich in einer Deflation endet, nicht eintreten wird." (SCHÜRFELD 1998, p. 549)

He mentions that due to the loss of the exchange rate instrument, readjustment might be a painful process which might also induce "a vicious circle … when everybody attempts to improve its competitiveness at the expense of the others" (DE GRAUWE 2007, p. 33). With the onset of the Euro crisis DE GRAUWE connected it with his analysis of the fragility of incomplete monetary unions (regarding crises in the government bond market) and he concluded:

> "Thus, the period during which countries try to improve their competitiveness is likely to be painful and turbulent: painful, because of the recession and the ensuing increase in unemployment; turbulen, because during the adjustment period the country can be hit by a sovereign debt and banking crises." (DE GRAUWE 2012, p. 131).

3.3 Structure and tasks of the ECB

In early editions of the textbook DE GRAUWE emphasizes that, following the model by BARRO and GORDON concerning time-inconsistent policies (BARRO/GORDON 1983), low-inflation countries have not much to gain from joining a monetary union whereas all he benefits accrue to high-inflation countries. Therefore, provisions are necessary so that the low-inflation country can be sure to get low inflation also in the future. In the wake of the discussion about the Maastricht treaty DE GRAUWE (1992, p. 160) proposes that

> "[f]irst, the statutes of the ECB should explicitly declare that the only macroeconomic objective of the European monetary policy is price stability. Thus, reference to high employment as an objective of monetary policy should be avoided. Secondly, the ECB should be institutionally independent of the political authorities …. Political independence is crucial to ensure that budget deficits of the national and European governments will not be financed by printing money."

That the Maastricht treaty contains exactly these proposals is a confirmation for DE GRAUWE "that the drafters of the statutes of the ECB have understood the basic asymmetry in the incentives of countries to join the EMU" (DE GRAUWE 1992, p. 161).

Two editions later, DE GRAUWE is somewhat less enthusiastic about these rules: he observed that during the 1990s growth in the prospective Eurozone countries was quite low and he conceded that there were "reasons to believe that the Maastricht strategy is at least partially responsible for the lacklustre economic growth observed during the 1990s. The main problem of the Maastricht convergence criteria is that they imposed a policy mix of budgetary and monetary restriction." (DE GRAUWE 1998, p. 136).

Apart from traditional tasks of monetary policy and the debate if it is to take care not only of price stability but also of high employment the first three editions contain nothing about the tasks of the ECB concerning financial stability and lender-of-last-resort function. These considerations are found only beginning in the 5th edition. Here, DE GRAUWE indeed predicts correctly

> "that the present distribution of responsibilities for maintaining financial stability in Euroland will become increasingly problematic as the integration of national banking systems in Euroland moves forward. Sooner or later a more rational organization of these responsibilities will be necessary. This will necessarily involve a centralization of the supervisory and regulatory responsibilities at the European level. This centralization means that the ECB should take responsibility for the lender of last resort function. The supervision may or may not be taken over by the ECB. It is also possible [and was recommended by DE GRAUWE in later editions, J.S.] that a new European authority may be created that would

> centralize the supervisory functions. Failure to move in this direction would subject Euroland to unnecessary upheavals when banking crises erupt." (DE GRAUWE 2003, p. 174).

Only in the 9th edition, after the outbreak of the Euro crisis, DE GRAUWE analyses convincingly the problem that for a member country can be forced into default by financial markets and that the central bank should also act as lender of last resort in the government bond market. This leads to the broader topic of fiscal policy in a monetary union that DE GRAUWE also treats in the textbook.

3.4 Fiscal policy on European and national levels

Concerning the debate about fiscal policy DE GRAUWE treats three issues: the (degree of) centralization of fiscal policy on a supranational/European level, the argument for fiscal rules and the problem of fiscal discipline in monetary unions in general which leads to a discussion about the default risks in a monetary union.

Indeed, from the very first edition DE GRAUWE pleads for the centralization of a substantial part of the budgets of the member states on the European level, e.g. by introducing a European unemployment insurance. This should help to dampen asymmetric shocks. If there is an increase in aggregate demand in Germany and a decrease in France the central European budget will help to dampen the boom in Germany and the recession in France. If such a centralization is not possible the traditional OCA theory would advocate flexibility in fiscal policy on the national level. "That is, when countries are hit by negative shocks, they should be allowed to let the budget deficit increase through the built-in … budgetary stabilizers." (DE GRAUWE 1992, p. 165).

But at the same time DE GRAUWE saw a "major problem" (DE GRAUWE 1992, p. 166) with this analysis: the problem of potentially unsustainable deficits – unsustainable in the sense that they might lead to ever-rising debt-to-GDP ratios which could either cause inflation (with spillover effects to other countries of the Eurozone) or might make large spending cuts and tax increases necessary. In DE GRAUWE's opinion this makes the case for rules for budget deficits in monetary unions. From the start he distrusts the argument that private capital markets are able to price the risk of default adequately. The reason for his distrust is that he thinks that capital markets assume an implicit bailout guarantee by other countries, even despite contrary rules (like the no-bailout clause in the Maastricht treaty).

> "For example, financial insitutions in other countries may hold Italian government paper. A default by Italy may lead to defaults of these financial institutions, and may create a general debt crisis. To avoid this, the governments of other countries may decide to step in and buy up the Italian government paper. The realization that such an implicit bailout guarantee exists will lower the risk premium on Italian government paper. Thus, the capital market fails to attach the correct price to risky Italian debt instruments." (DE GRAUWE 1998, p. 199)

Nevertheless DE GRAUWE criticizes the SGP from the third edition onwards for being too rigid and not flexible enough.

An interesting discussion in his textbook is the debate about fiscal discipline in a monetary union and the problem of defaults. The question here is: does a monetary union lead to higher

or to lower deficits, that is, does the membership in a monetary union give incentives for member countries to increase their deficits or not? A related question is whether the probability of defaults increase or decrease when a country is a member of a monetary union.

For DE GRAUWE, there are two conflicting processes that are both caused by the fact that in a monetary union a government can only issue bonds in a 'foreign' currency (he was clear about this feature but without seeing the consequence that countries can be forced to default by the financial markets). The incentive for higher deficits comes from the fact that the risk premium could decrease when a country abolishes its national currency and joins a monetary union: if a sovereign country issues bonds in its domestic currency, the risk premium consists of two components: the premium for the default risk and the premium for the devaluation risk. As the devaluation risk disappears when a country joins a monetary union one is left with the default risk. If capital markets assume an implicit bailout guarantee of other member states this default risk premium is not very large, leading to large deficits. On the other hand, countries can no longer finance their deficits by money creation; they face a harder budget constraint which diminishes their incentive for high deficits. (DE GRAUWE 1998, p. 200 f.) At first sight, it is unclear which process prevails but in later editions DE GRAUWE shows that the second effect seems to be more important if one looks at the data since 2000:

> "We observe that while the debt to GDP ratios of the USA and the UK more than doubled, the Eurozone's government debt-to-GDP ratio increased by only 34% during the existence of the monetary union. Thus, the second (no-monetization) effect seems to play a stronger role than the moral hazard effect." (DE GRAUWE 2018, p. 233 f.)

Nevertheless, starting from the 3rd edition, DE GRAUWE pointed to another problem, referring to a report by MCKINNON (1996) who stated that the default risk might actually increase in a monetary union.

> "As soon as a country joins a monetary union it loses control over the central bank, and therefore cannot create surprise inflation to reduce the burden of its debt any more. As a result, pressure on the government to organize an outright default may actually increase in a monetary union. MCKINNON (1996) argues that this will happen in EMU. The level of the debt of certain EU countries is so high that in the absence of implicit defaults by inflation and devaluation, the probability that outright default will occur increases." (DE GRAUWE 1998, p. 203)

Up to the 8th edition, DE GRAUWE also mentions the counter argument given in a paper by EICHENGREEN/VON HAGEN (1995) that default risk in a monetary union is low as long as the member countries maintain control over a large domestic tax base and therefore the imposition of tight rules on the member countries has been over-emphasized (DE GRAUWE 204 f.). But from the 9th edition onwards, this counter argument disappears – due to the experiences with defaults in the Eurozone.

But although the report by MCKINNON showed "remarkable foresight of what was to come" (DE GRAUWE 2018, p. 237) he still connected the default risk closely with the amount of government debt or the debt-to-GDP ratio, respectively. This might be relevant for Greece, but cannot explain the example of Spain which until 2012 had a debt-to-GDP ratio lower than Germany's. Here, on the other hand, DE GRAUWE was – even before the outbreak of the Euro crisis

– correct to connect the size of government bond spreads to the relative competiveness of countries, measured by the development of their relative unit labour cost (DE GRAUWE 2009, p. 242 f.)

4. Selected statements by Economists

4.1 The German manifestos against the Euro

In 1992 and 1998 a group of Economics professors published two manifestos against the introduction of the Euro in two leading German newspapers (OHR/SCHÄFER 1992, KÖSTERS ET AL. 1998). They were rather short but led to a heavy discussion about the pros and cons of monetary union. The first manifesto was signed by 60 economics professors, the second by 160. What did the manifestos warn against?

The first manifesto concentrated on the inflationary dangers in the Eurozone. According to the authors, the ECB "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" (OHR/SCHÄFER 1992, p. 3). Furthermore, the authors claim that there is no Europe-wide consensus concerning price stability and that the necessary support from fiscal policy as well as from wage policy is lacking. It is interesting that wage policy is mentioned in the manifesto but there is no further clarification how this support should look like. As the authors of the second manifesto talk about the necessity of wage flexibility (KÖSTERS ET AL. 1998, p. 7) it is doubtful if this support is thought along the lines sketched by FLASSBECK (1997) and other more Keynesian authors.

Furthermore, the authors demand a real convergence, e.g. also in terms of productivity, because "[t]he 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." (OHR/SCHÄFER 1992, p. 3). This is of course only correct if the states do no longer strive for the same inflation goal, because only in this case a devalution could be helpful; devaluations are not able to compensate for different levels of productivity. Normally that would not be a problem if the lower productivity is connected with lower wage levels. Therefore this critique only makes sense if one assumes that inflationary developments are persistently different.

The fear of inflation also dominated other economic commentators in Germany. MANFRED NEUMANN finished a survey article on economic policy (NEUMANN 1996, here p. 119) with a criticism of the alleged constraint on the ECB's independence. According to NEUMANN, this is due to the fact that the ECB has to support the general economic policy of the European Union, that classical open market policy with government bonds is allowed and that the ECB does not have the competence for exchange rate policy. Furthermore, NEUMANN seems to think the way how the presidents of the national central banks are chosen could lead to the election of weak candidates whose aversion to inflation might not be strong enough.

The problem of inflation has less prominence in the second manifesto that was published nearly one year before the start of the EMU. The authors now place a greater emphasis on the convergence criteria, especially the criteria concerning deficits and debt. That the debt ratio is now – at the date the manifesto was published – 15 percentage points higher than 1991 is seen as "contrary to the spirit of the treaty" (KÖSTERS ET AL. 1998, p. 7). The authors emphasize the importance of consolidation of public budgets and give a good example of the obsession-like occupation with budget deficits that seems to be a characteristic trait of many German economists at that time.[2]

Furthermore, the authors again mention structural problems within the Eurozone, but surprisingly their focus now is not on the Europen periphery, but on Germany and France who

> "are not well prepared to cope with the more rapid structural change and the siffer competition in a monetary union. … [L]abour 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." (KÖSTERS ET AL. 1998, p. 7)

Apart from the manifestos the lawsuit brought to the German constitutional court by four economics and law professors (HANKEL ET AL. 1998) was heavily discussed in the German public. It will be discussed (together with the statements of the German council of Economic experts) in a later version of this paper.

4.2 At the Cusp of Monetary Union: WYPLOSZ vs. FELDSTEIN

In 1997 the Journal of Economic Perspectives published two papers: one by CHARLES WYPLOSZ, one by MARTIN FELDSTEIN who both assessed the pros and cons of monetary union: Whereas WYPLOSZ was at least mildly optimistic of the project, FELDSTEIN warned massively against it, calling it an economic liability. What were their arguments?

4.2.1 CHARLES WYPLOSZ

WYPLOSZ starts with the statement that EMU is indeed a logical step following the previous steps of monetary integration: after the introduction of the Single European Act in 1986 which eventually lifted all restrictions on capital movements and the success (at least in terms of inner-European exchange rate movements compared with fluctuations vis-à-vis the dollar) of the European Monetary System (EMS) the European countries had lost the monetary independence – with the exception of Germany. "By the late 1980s it had become obvious that the Bundesbank, Germany's central bank, was setting monetary policy for Europe as a whole." (WYPLOSZ 1997, p. 5) Besides its economic size Germany had a reputation as inflation fighter which made it an attractive anchor for the other European countries; as a corollary they lost their monetary independence. Therefore, his final vindication of EMU rests on the problems connected with the situation at the end of the 1980s:

> "The Maastricht Treaty only came about because the lifting of capital controls had reduced the alternate options to just two unpalatable extremes: either allow exchange rates to float

[2] The statements of the German council of economic experts concerning the European Monetary Union have a similar one-sided focus on the problem of the consolidation of public budgets – and that did not change in the Euro crisis.

> freely or accept the complete domination of Germany's Bundesbank over Europe's monetary policy. … On one hand, the Bundesbank derives its leadership from a reputation of undeterred commitment to price stability in Germany. On the other hand, long-lasting leadership requires that all of Europe's economic conditions be taken into account, which is against the Bundesbank's constitutional duty to Germany. Tinkering with the Bundesbank's constitution is not only politically impossible, but doing so would also undermine its credibility and its ability to lead. In this setting, EMU emerges as the best possible economic solution." (WYPLOSZ 1997, p. 18)

WYPLOSZ discusses three points concerning the set-up of the monetary union: the criteria according to the theory of optimum currency areas (OCA), the content of the Maastricht Treaty – expecially its convergence criteria – and the problems of fiscal policy.

Concerning the OCA criteria WYPLOSZ reaches the usual conclusion that the potential member countries do not form an optimum currency area. But he seems to have some sympathy for the idea that these criteria can be endogenous and that at the end of the 18th century the United States might not have been regarded as an optimum currency area – but that does not necessarily lead to the conclusion that they should not have introduced the dollar (WYPLOSZ 1997, p. 10).

With regard to the five convergence criteria in the Maastricht Treaty WYPLOSZ emphasizes that in all issues the German view has prevailed: it insisted on the strict control of the deficit and debt ratios stated in the Treaty due to fear of inflation.

> "Moreover, the statutes and objectives of the European Central Bank remarkably resemble those of the Bundesbank: strong independence from government, responsibility clearly limited to price stability, no explicit involvement in bank supervision, and no lender-of-last-resort function." (WYPLOSZ 1997, p. 7)

Especially the last three points became a problem in the first years of the Euro crisis because it increased the insecurity on the capital markets. WYPLOSZ does not seem – at least at the time of writing – to see these gaps as serious deficiencies of the EMU but he mentions the possibility that trying to reach the proposed debt and deficit ratios has lengthened the period of insufficient aggregate demand, stagnation and unemployment in Europe in the 1990s (WYPLOSZ 1997, p. 11 f.).

The problem of fiscal discipline is discussed quite intensively in WYPLOSZ's paper. He states that many economists stated that with the loss of the exchange rate as a policy instrument fiscal policy becomes more important as a stabilizing device (WYPLOSZ 1997, p. 12) whereas monetary authorities seemed to be more concerned with the danger of having to monetize (part of) government debt. "They feared that an explicit or implicit lender-of-last-resort function might force the European Central Bank to step in and indirectly monetize a country's public debt if banks faced a financial crisis in the wake of a default." (WYPLOSZ 1997, p. 13) WYPLOSZ discusses the difficulties of defining the long-term sustainability of government debt and doubts whether the ratios concerning debt/GDP and deficit/GDP in the Maastricht Treaty are reasonable. A limit on deficits of sub-central governments might be sensible if there is a strong central government smoothing out economic fluctuations via transfers between the regions. But as there is no powerful central European government, stabilization policy on a national level is still needed "and there is no risk that national governments will conduct irresponsible fiscal policies in an attempt to extract transfers from a penniless center" (WYPLOSZ 1997, p. 14). Furthermore, WYPLOSZ refers to a paper by VON HAGEN/EICHENGREEN (1996) that comes to

the conclusion that strict fiscal rules may even contribute to the problem of demanding bailouts that the rules want to avoid: "If the tax-smoothing and automatic-stabilization capacities of national governments are hamstrung, national officials will lobby for these services to be provided by the EU, leading to the transfer to Brussels of power to tax and expanding transfers to member states." (VON HAGEN/EICHENGREEN 1996, p. 137).

Interestingly, WYPLOSZ briefly mentions the problem of handing over to capital market the power to control government deficits via interest spreads. In theory, capital markets might price the different risks of borrowers but he does not think that markets are good at that.

> "When markets do react, it is often too late and too violently. They abruptly cut financing, making it impossible for the government to borrow further and bankrupting large bondholders, among them commercial banks and other financial institutions. This leads to a scenario where central banks may feel compelled to monetize (part of) the debt." (WYPLOSZ 1997, p. 14).

This statement at least pointed to the potential problems of governments depending on the volatile assessments of capital markets for their finance. It did not, of course, foresee all aspects of this problem but in a nutshell, it is a quite prophetic description of what happened in the Euro crisis.

4.2.2 MARTIN FELDSTEIN

In contrast to WYPLOSZ, FELDSTEIN does not see an economic case for the EMU; he regards it as primarily driven by political considerations whereas a narrow economic assessment leads him to the conclusion that the standard of living will be lower in the medium and long term if EMU is realized (FELDSTEIN 1997, p. 24). He sees as major political motives that Europe – or at least many European politicians – strive for greater unity to pursue a more independent European foreign policy; he leaves open the question whether that development really would serve European or worldwide peace better than existing security structures, e.g. the NATO (FELDSTEIN 1997, pp. 25 ff.).

Furthermore, there are national interests in EMU but these sometimes are contradictory: France wants greater equality with Germany in terms of economic policy, especially monetary policy, and hopes to end the dominance of the Bundesbank. Some German politicians might actually be convinced that EMU will contribute to peace in Europe but many hope that the rules of the Maastricht treaty and the stability pact might bring the discipline wanted by many Germans and strengthen the dominance of Europe by Germany. "It is clear that a French aspiration for equality and a German expectation of hegemony are not compatible. But both visions of the future drive their countrymen to support the pursuit of EMU." (FELDSTEIN 1997, p. 29)

FELDSTEIN has also a sceptical view concerning the wish of especially smaller countries to have a seat at the table where the relevant policies are discussed and made: he thinks that due to qualified-majority voting and the fact that often only one representative of a group of smaller countries participates in meetings will make the influence these countries strive for illusory (FELDSTEIN 1997, p. 30).

Concerning the economic aspects of EMU FELDSTEIN considers the positive efficiency effects (reduced transaction costs from using the same currency) as quite small; furthermore, he does

not see the net effect from the removal of exchange rate fluctuations as necessarily positive: the disappearance of intra-European fluctuations could be connected with larger fluctuations between the Euro and other currencies, like the US-Dollar or the Japanese Yen. (FELDSTEIN 1997, p. 33 f.).

FELDSTEIN predicts an increase of (average) cyclical unemployment if EMU goes ahead (FELDSTEIN 1997, pp. 34 ff.). This is due to the fact that a member country of the EMU loses its ability to make monetary policy and that automatic monetary stabilizers (decrease of real interest rate and of the real value of the currency) can no longer work. This is especially problematic as the prospective member countries of EMU do not fulfil the requirements for an optimum currency area: they are quite heterogenous, have rather rigid wages and prices (according to FELDSTEIN, flexible wages and prices would quickly reinstall full employment), the labour force is not mobile and fiscal transfers from the European center are practically non-existent.

Concerning inflation FELDSTEIN thinks that the rate of inflation will go up when the ECB has the sole responsibility for price stability. Although he concedes the strict orientation towards price stability in the Maastricht treaty he nevertheless emphasizes that there is no tradition for independent central banks in Europe. Furthermore, as the members of the governing council of the ECB are appointed by the governments of the member countries, and that the council will decide by simple majority the anti-inflationary stance of Germany may no longer be sufficient to avoid a – in FELDSTEIN's opinion – too expansionary monetary policy. The representatives of other countries in the ECB's Governing Council "may reflect their national attitudes and be subject to political pressure to represent what domestic governments perceive to be national interests" (FELDSTEIN 1997, p. 37), and the high unemployment rates in Europe at that time might give additional incentives for that. Additionally, FELDSTEIN thinks that there is no European tradition of supporting independence of the central bank. "There is no reason to believe that the voters in Europe are prepared to leave the making of monetary policy to a body that is beyond political control." (FELDSTEIN 1997, p. 38) He cites statements by the then French president, FRANÇOIS MITTERAND, about an economic government that is to exert control over the ECB; the elimination of automatic penalties from the stability pact; the (potential) role of the Council of Economics and Finance Ministers (ECOFIN) concerning exchange rate policy (the demand for a devalution of the Euro vis-à-vis other currencies might cause an easier monetary policy) and the "accounting gimmicks" (FELDSTEIN 1997, 39) to make sure that the deficit criteria are met.

In contrast to WYPLOSZ who said that EMU might be the best possible solution due to the contradiction that the Bundesbank sets the monetary policy for Europe without taking into account the economic situation outside Germany FELDSTEIN defends the situation before EMU:

> "The current system of fixed but adjustable exchange rates and the leadership of the Bundesbank have worked will in creating a climate that has led to increasing price stability in Europe since the early 1980s. The shift to a new and untried European Central Bank and the associated 'stability council' would at best be a gamble with future inflation." (FELDSTEIN 1997, p. 40)

Finally, FELDSTEIN sees EMU as a potential cause for an increase in structural unemployment – for him the bulk of unemployment in Europe at that time. To combat it one has to introduce

reforms that reduce the costs of employment (lower minimum wages, lower payroll taxes, loosening of work rules, etc.) and increase efficiency to increase a nation's competitiveness. FELDSTEIN thinks that this will become more difficult after the start of the EMU as the possibilities of the member states for individual labour-market policies will be reduced. "A politically more unified Europe would make it easier to enforce European-level policies that would prevent a nation from seeking to increase its competitiveness or to reduce its structural unemployment through changes in its labour laws or transfer payments." (FELDSTEIN 1997, p. 40)

I think it is fair to say that the development in the Eurozone is the complete opposite of FELDSTEIN's fear: especially Germany could improve its competitiveness and was no longer "hindered" by later appreciations of the currency that often foiled earlier attempts of increasing competitiveness by moderate wage policies – the suspected legislation preventing Eurozone countries from such policies never took place.

It is equally interesting what Feldstein does *not* discuss: he barely mentions the restrictions for fiscal policy in the stability pact – the fact that he criticizes the 'accounting gimmicks' indicates that he supports these restrictions as a way of precluding inflationary developments. Fiscal policy as a tool for stabilisation does not play a role: if there is a need for it, it is only monetary policy. Furthermore, problems of financial stability are not touched upon at all.

5. Conclusion

This first and very preliminary excursion in the literature before the start of the European Union showed that indeed the actual problems that came up in the Euro crisis – current account imbalances due to unsustainable financing decisions of private agents (instead of the government) and due to diverging competitive positions of the member countries; the problem of government defaults forced by financial markets due to a missing lender-of-last-resort function of the central bank; and the lack of a fiscal capacity on the European level – were often not or only barely mentioned in the literature.

Of course this paper is only the start of such an investigation that looked at some prominent examples in the Euro debate before and until 1998. Further publications have to be analysed before a definite conclusion can be reached concerning the main topics of the Euro debate. Apart from German and English contributions it would be desirable to look also at the debates in other member countries of the Euro zone. Furthermore, a look into the debate in the newspapers at that time would be desirable.

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