



THE FUTURE OF THE EURO

Edited by

MATTHIAS MATTHIJS

and

MARK BLYTH

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The Future of the Euro

For Tony Judt

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Foreword

ONE OF THE more minor consequences of the 2007–2008 global financial crisis was some serious soul searching among economists and political scientists for having failed to predict these events. Given its “black swan” nature—low probability and high impact—we might all be forgiven. However, the European sovereign debt crisis that followed two years later invites no such sympathy. There is neither ambiguity about its nature nor its timing, only its final resolution.

The European sovereign debt crisis was in many ways the inevitable consequence of the US financial crisis reaching European shores. But why then, if it was inevitable, were policymakers so blindsided? The euro crisis has called into question the long-term viability of Europe’s Economic and Monetary Union. In order to better understand what has gone wrong, how the Eurozone could potentially be fixed, and what the future(s) of the euro might be, including its possible failure, this volume brings together the insights of a dozen scholars on the political economy of Europe, from both Europe and the United States.

This volume is organized according to the various contributors’ scholarly expertise and research interests. While a division of labor is a core characteristic of edited volumes, this volume is unique in two respects. First of all, the chapters actually agree to a considerable extent on the main features of the euro and its crisis. Second, they directly engage with and build upon one another. As a result, the whole of the book is much greater than the sum of its parts. We hope that you, the reader, agree with this assessment.

There are many people we would like to thank who have been involved with this project, and we apologize in advance if we omit to mention them here. First of all, this book would not have been possible without the generous funding made available by the Bernard L. Schwartz Globalization Initiative at the School of Advanced International Studies (SAIS) at Johns

Hopkins University. Its academic co-chair, Pravin Krishna, was enthusiastic from the start about the project, and the initial December 2012 workshop in Washington was a success thanks to the research assistance of Ryan Connelly. We are most grateful for all the logistical, administrative, and managerial support from the Initiative's program manager at SAIS, Kelley Kornell. Dean Vali Nasr and Associate Dean for Academic Affairs John Harrington also deserve mention for all their encouragement, and for creating an environment of academic excellence at SAIS.

We also want to thank the Watson Institute for International Studies at Brown University, for sponsoring a conference on the euro crisis in April 2012, where the idea for this edited volume was born. Our conversations with Alfred Gusenbauer, Romano Prodi, and especially Martin Wolf at Brown were particularly enlightening.

It goes without saying that this volume is very much a collective effort, so we owe an immense gratitude to the chapter contributors Kathleen McNamara, Erik Jones, Nicolas Jabko, Vivien Schmidt, Abraham Newman, Mark Vail, Jonathan Hopkin, Wade Jacoby, Craig Parsons, and Eric Helleiner. Furthermore, we want to thank the Council of European Studies for allowing us to build a three-panel symposium around this book project during their annual International Conference of Europeanists in Washington, D.C., in March 2014, as well as Randall Henning, Craig Parsons, and Charles Kupchan for agreeing to serve as discussants on those panels. Others who deserve to be mentioned for their encouragement and sound advice include Jonathan Kirshner, Peter Hall, Dan Drezner, Dan Kelemen, Cornel Ban, Simon Tilford, and Jerry Cohen.

A special mention goes to Björn Bremer, who provided invaluable research assistance during the writing and editing stages of this book. He compiled the bibliography, and proved to be a meticulous editor and proofreader of all the chapters and endnotes. Brian Fox was instrumental in carefully putting together the index for the book. We also thank David McBride and Sarah Rosenthal at Oxford University Press for ably steering the manuscript through the publication process, as well as the very helpful comments from the two anonymous reviewers.

Finally, together with all our contributors, we decided that we wanted to dedicate this book to the late Tony Judt. The debate over the euro crisis was from its inception dominated by financial experts and economic analysts. Judt's unique historian's voice was often very much missed. We think that Judt would have been sympathetic to the main message of this book—that any long-term solution to the crisis experienced by the European Union and

its single currency should begin by addressing the political foundations of markets. Tony Judt taught all of us a great deal about Europe and its historical development. We owe him a tremendous intellectual debt. He passed away too soon without leaving us his understanding of what went wrong in this moment of crisis and where we should go from here. With his voice in our ears, we have tried to fill that silence. Whether our collective efforts are worthy of being mentioned in the same breath as Judt's is, however, something that, once again, we will leave to you, the reader, to decide.

Matthias Matthijs and Mark Blyth
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I

Introduction

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

Matthias Matthijs and Mark Blyth

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