

The background of the book cover is a solid reddish-brown color, overlaid with a repeating pattern of dark grey Euro currency symbols (€).

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The Politics of the Euro-Zone

Stablility or Breakdown?

Kenneth Dyson

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THE POLITICS OF THE EURO-ZONE

To
my son Thomas

Principles can only lose their vitality when the first impressions from which they derive have sunk into extinction; and it is for you to keep fanning these continually into fresh flame.

(Aurelius 1964: 105)

We have slain a large dragon, but we now live in a jungle filled with a bewildering variety of poisonous snakes.

(Mueller 1994: 336)

PREFACE AND ACKNOWLEDGEMENTS

As will become apparent, this book is a first, tentative and provisional attempt to capture the nature, implications and challenges consequent on a new, unique and uncertain venture. It should, accordingly, be read with a degree of indulgence, for the reader will possess in unusual abundance that most precious gift of which this writer is deprived: hindsight.

The book was written during a sabbatical semester between February and September 1999, in the immediate aftermath of the establishment of the Euro-Zone on 1 January. My purpose was to try to offer a political analysis of the nature and implications of this momentous event. Despite the inability at this stage to produce a narrative history of the Euro-Zone, there seemed three good reasons to attempt a book on the politics of the Euro-Zone. First, scholars who were working on other aspects of the politics of European integration, and students in particular, urgently needed an analytical guide to, and a critical overview of, the structure and functioning of the Euro-Zone. There was, in addition, a need to balance the domination of economists in commentary on the Euro-Zone by offering a picture of the Euro-Zone, especially its prospects for stability, from a political-science perspective. Finally, the present book might help to stimulate an interest in the importance and implications of the Euro-Zone beyond short-term partisan considerations, focusing for instance on the weakness of the euro in the international foreign exchange markets in 1999.

On a more personal level, my colleague Kevin Featherstone and I had finished preparing our book *The Road to Maastricht* for publication. I was attracted by the idea of moving away from an essentially historical exercise of looking back at how EMU had been negotiated to the task of trying to discern what was currently happening, what the parameters were within which the Euro-Zone was developing, and the nature of the challenges facing its policy makers. It seemed vital to analyze the links between the European Central Bank (ECB) and the wider aspects of economic policy, as well as issues of legitimacy, before the Euro-Zone had to cope with its first major crisis.

Preface and Acknowledgements

As I began to write, I became increasingly aware of the difficulties surrounding this task and, above all, of the hostages to fortune in coming to any judgements about so complex and multifaceted a phenomenon. I began to see myself as an explorer of uncharted territory. This analogy seemed to capture well the sense of adventure that accompanied my writing. But it also brought home memories of just how silly early maps could look when compared with later, more sophisticated versions.

I am grateful to the Department of European Studies at the University of Bradford for making it possible to write this book, especially to its head, Roberto Espindola. In addition, my writing has benefited greatly from the unfailingly generous advice of colleagues. Kevin Featherstone and Claudio Radaelli, in particular, have offered help and encouragement in every way. Margaret Haldane has provided invaluable secretarial help in preparing the manuscript for publication with her dependable, quiet efficiency. To colleagues and to Margaret I am extremely grateful. My thanks are also due to OUP's anonymous reviewers for their positive and constructive criticisms.

My son Thomas encouraged me to develop the Kantian theme that came to play a larger theme in the book than I had originally intended. I have gained much from conversations with him and thank him in particular for always being there to offer counsel and support. For that reason the book is dedicated to him.

KENNETH DYSON

Bradford, December 1999

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Introduction

THE motives for writing a book are made clearer by an examination of the context in which it is situated. Hence this Introduction begins by tracing the background of both the practical political and economic developments within the European Union (EU) and the relevant academic literature.

The birth of the Euro-Zone was the most momentous event in the international monetary system since the collapse of the Bretton Woods system in 1973. It was also the most important act in European institution-building since the Treaty of Rome in 1957 established the European Economic Community. In a unique manner, sovereign states agreed to replace their national currencies and central banks by a new single currency and a new central bank to manage that currency. The currencies of eleven of the 15 EU member states—the Euro-11—were ‘irrevocably’ locked together so that they became denominations of a single currency, the euro. Strictly speaking, there was no longer a foreign exchange market in these currencies. The old exchange rate mechanism (ERM) that had bound them together was dead, along with the sorts of crises—like those of 1992–3—that had threatened European unity. Fixed exchange rates, as under Bretton Woods, and the stable but adjustable exchange rates of the ERM had disappeared in favour of a unified currency system, albeit one with national currency units still in existence. By July 2002 the euro was to replace these currencies to become the sole currency of legal tender. With respect to exchange-rate policy and interest-rate policy, European states seemed to be ‘in retreat’, denying themselves the use of key policy instruments.

The shift in power was most immediately visible with respect to the Deutsche Bundesbank. Till 1999, as the guardian of the most stable and ‘hard’ currency in the ERM, Bundesbank monetary policy had provided the ‘anchor’ for other EU currencies. It was, in

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effect, 'the bank that ruled Europe' (Marsh 1992; Heisenberg 1999). Now, the revised Bundesbank Law of 1998 redefined its role in section 3: 'the Deutsche Bundesbank is, as central bank of the Federal Republic of Germany, a part of the European System of Central Banks.' The duties of the Bundesbank Council changed. It no longer determined the monetary policy of the Bundesbank, only its business policy. According to section 6 of the 1998 law, in discharging the duties of the ESCB, the Bundesbank Council acts in accordance with the guidelines and instructions issued by the ECB (Deutsche Bundesbank 1999a: 21–2). The most important task of the Bundesbank is henceforth the implementation of the monetary policy decisions taken by the ECB governing council by means of general guidelines and instructions (Tietmeyer 1999a).

Given the size of the Euro-Zone economy, the euro's international dimension was also bound to be significant (Bénassy-Quéré *et al.* 1994; Henning 1997). The Euro-Zone was a major new player in international economic and monetary co-operation, albeit one hampered in this role by its lack of a single voice in this arena equivalent to that of the US Treasury Secretary. Its impact on the international monetary system was likely to be felt through its choice as a reserve currency, its adoption as an anchor currency, and its use as a vehicle currency in international trade (Padoa-Schioppa 1998). The speed with which the euro took on these roles depended, in turn, on two factors: the development of deep and liquid euro financial asset markets, notably euro-denominated bond markets (Portes and Rey 1998); and market perceptions of the relative strength, vitality and prospects for the Euro-Zone economy compared with the US. The euro was important in triggering structural changes within financial markets and the banking sector, especially in money and bond markets. These changes, like the alliance between the London Stock Exchange and the Deutsche Börse, pointed in the direction of a more integrated EU financial market. But the US economy proved, at least initially, a good deal more attractive to market operators, leading to a weakening of the euro *vis-à-vis* the dollar. Hence the euro started life as a residual currency in a tripolar world of dollar and yen. Even so, the euro was potentially a serious rival to the US dollar in international financial markets. Its rise might also generate instability in the absence of co-ordinated international management of the euro, dollar and yen.

There were profound implications for EU member states. They had traded in two of the most potent symbols of their macroeco-

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conomic autonomy: their ability to resort to using devaluation and interest-rate changes to influence their economies. They had also subjected themselves to rigorous fiscal constraints. In addition to being deprived of these traditional instruments of economic adjustment, member states were also subject to the long-term impact of the euro on internal trade and competition (Rose 1999). In this context labour-market, wage-policy and welfare-state reforms were highlighted (Ebbinghaus and Hassel 1999). The political agenda shifted to a focus on reducing labour costs, on improving incentives to work, on greater labour-market flexibility, and on active employment policies. The methodology of learning by 'benchmarking' best practice assumed a new importance in relation to these issues.

This 'benchmarking' approach was apparent in the preparation of the special European Council summit in Lisbon on innovation, employment and social cohesion by the Portuguese government under Antonio Guterres in 2000. At the heart of this interest was a view that European states must seek to redefine their economic policy role by taking the lead in opinion formation, acting as a catalyst in the formation of ideas, and seeking collaboration with business about best practice (cf. Marsh 1999). Guterres understood it as an 'open co-ordination method' using 'light' policy instruments to promote and simplify the process of convergence in the Euro-Zone. It was especially appropriate to an agenda of microeconomic reforms to promote innovation, competitiveness and social cohesion so that Europe could be set on a route to sustainable growth (*Financial Times* 2000).

In pursuing a political agenda of competitiveness through structural, supply-side reforms, national governments faced potentially high and dangerous political costs. Pressures for structural change were in any case built into the creation of the Euro-Zone. They took the form of major microeconomic changes consequent on the greater transparency of prices and costs, the elimination of currency transaction costs, and a more integrated market with a consequent search for new economies of scale on a Euro-Zone-wide basis. Member states anticipated an increase in the rate of economic restructuring as firms sought to capture the opportunities opened up by the Euro-Zone and to ward off new competitive threats. In that context the promotion of a more 'knowledge-based' and 'socially inclusive' society based on 'benchmarking' best practice gained a new attraction in areas like venture-capital provision, core

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educational and skill competences, and social policy. The Lisbon summit was a first attempt to flesh out this new approach.

This process of policy learning through 'benchmarking' best practice had the potential to create convergence and thereby facilitate collective identity formation in the Euro-Zone. However, the prospects for convergence were qualified by a continuing diversity in the way in which member states defined their economic policy role. This diversity revealed the impact of historical legacies of policy ideas and the institutionally-conditioned and 'path-dependent' nature of policy change. Thus, in line with other Anglo-Saxon countries, the British New Labour government of Tony Blair placed key emphasis on flexible labour markets, liberalization of goods and service markets, and a market-oriented welfare state. In contrast, the Dutch, Irish, and Italian governments pursued tripartite concertation in the form of 'social pacts' between government, employers and trade unions. Here wage restraint was compensated by new employment schemes and tax cuts. The contrast between the British and Dutch models amounted in effect to the difference between the confrontational, 'winner-takes-all' style of the 'majoritarian' form of liberal democracy and the consensual form of 'non-majoritarian', negotiated democracy (Lijphart 1984). Each could offer a credible model of domestic policy reforms, with Britain and the Netherlands having each improved performance in raising economic growth and reducing unemployment since 1994.

More serious for the Euro-Zone was the greater inertia of France and Germany with respect to supply-side reforms. In both these core states of the Euro-Zone governments lacked an appropriate combination of political will and capability either to push through labour-market, wage, and welfare-state reforms in the British manner or to negotiate national social pacts in the Dutch manner. In the French case tripartite consultation faced the problem that employers' organizations and trade unions were unable to regulate the labour market and the welfare system in an effective way. The adoption of the British model was ruled out by ideological opposition to the Anglo-Saxon capitalist model of primacy to markets. French governments favoured a catalytic role for the state in growth and employment based on the idea of a controlled globalization. In Germany a central problem for negotiating a national social pact under Chancellor Gerhard Schröder was the constitutional guarantee of autonomy of collective bargaining. This guarantee undermined efforts to co-ordinate wage policy with other reform

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measures. Importing the British model ran up against ideological attachment to the 'Rhineland' model of co-operative capitalism, in which labour was seen as a key stakeholder in industry. To this ideological difference was added the difficulties of pushing reforms through a federal political structure, as well as a federal government in which ministries had a high level of autonomy. The resultant uncertainty about the capacity of France and Germany to undertake domestic policy reforms cast a shadow of doubt over the prospects for the Euro-Zone.

There remained, in short, differences in the way that European states construed their economic policy role. The Euro-Zone was an important factor in encouraging a more important part for 'benchmarking' best practice in how that role was construed. At the same time the process and effectiveness of policy importing was conditioned by its consistency with domestic institutional practices and historically conditioned policy ideas. For that reason the Dutch model of negotiated change was more likely than the British model to appeal in Germany, whilst French elites were likely to be resistant to both models and to favour a more active and independent role as a 'developmental' state. In consequence, diversity of domestic policy behaviour over labour-market, wage-policy and welfare-state reforms was likely to qualify policy convergence and collective identity formation within the Euro-Zone. Differences of domestic ideologies and institutional patterns continued to matter, especially in conditioning the scope and direction of cross-national policy transfer and lesson-drawing.

However, the relationship between policy learning through 'benchmarking' best practice and domestic ideologies and institutions is more complex. 'Benchmarking' can be a factor in reframing domestic discourse and shifting the distribution of power over ideas and agenda-setting. Where domestic institutions are shown by this means to be failing to deliver a defensible performance, their legitimacy can be eroded. The result is an opening for new policy ideas to restructure domestic debate and for domestic policy reformers to exploit this opportunity to effect policy change. This process was apparent in Italy during the 1990s and Greece as it sought Euro-Zone entry by 2001. Policy convergence through learning may be qualified and imperfect, for the reasons outlined above. Nevertheless, when one considers cases like Greece, Ireland, Italy, Portugal, and Spain it is evident and offers the basis for an emerging collective identity formation.

Existing Literature

From the mid-1980s onwards a substantial literature on economic and monetary union (EMU) in Europe has emerged. Its growth has paralleled the return of EMU to the agenda of the European Community, its negotiation in the Treaty on European Union at Maastricht in 1991; and the progression from stage one in 1990, through stage two on 1 January 1994, to the final transition to stage three on 1 January 1999. This literature has had two main axes of development: mainly political science-based accounts of the history of EMU and the process of its negotiation (for example, Dyson 1994; Dyson and Featherstone 1999; McNamara 1998; Moravcsik 1999; Verdun 2000), and economic analyses and assessments of the conditions for a sustainable EMU (for example, De Grauwe 1992; Gros and Thygesen 1992; Kenen 1995). Others have offered a 'political economy' of EMU (for example, Frieden, Gros, and Jones 1998).

As a consequence, we know a good deal about how and why EMU was negotiated and about the underpinnings of EMU in economic theory. The political strategies and tactics of EMU negotiators in the design of EMU and the nature of domestic debates are better understood, as is the role of ideas and technical experts in the negotiations. It is possible to identify the impact of economic ideas about policy credibility; for instance, on the primacy given to central bank independence in the design of EMU. Drawing on the literature on 'optimum currency areas', economists have also contributed a critique of the missing elements of fiscal federalism and of labour-market mobility and flexibility in the Euro-Zone. In so doing they have highlighted the risk of persistently high structural unemployment as a source of tension, weakness and potential crisis. Typically, they have pointed to the urgency of reform of labour-market institutions, especially collective bargaining, job security legislation, and unemployment benefit systems (for example, Vinals and Jimeno 1998).

But, with the historic transition on 1 January 1999, the literature has to come to grips with a new and unique experiment in modern governance. What is now most in need of clarification is a range of political questions about the nature, meaning and implications of the Euro-Zone. This book is concerned with the politics of the Euro-Zone. Given its novelty a narrative form is not possible. Instead, the emphasis is on its structure and functioning, examining the nature of the relationships on which it is built, analysing the problems that it faces and evaluating prospective reforms.

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A literature on the Euro-Zone, informed by political science, has begun to emerge (for example, Crouch 2000; McKay 1999b; Wessels 1998). Institutional deficiencies, notably in policy co-ordination and in accountability, have been identified (Buiter 1999; Taylor 2000). In a larger EU context questions about democratic governance, legitimacy and the 'democratic deficit' have been addressed (Beetham and Lord 1998; Radaelli 1999; Scharpf 1999; Verdun and Christiansen 2000). If EMU forces a degree of central fiscal co-ordination and redistribution, representative institutions will have to be strengthened and a stronger citizen identity created (McKay 2000). Political scientists are also interested in the implications of EMU for the 'European model of society', in particular for social-policy provision and for labour-market regulation (Leibfried and Pierson 1995; Martin and Ross forthcoming). The external implications of the euro for the international monetary system have also received attention (Henning 1994 and 1997). Concerns have been expressed about whether the Euro-Zone is prepared to take on a wider international responsibility by tailoring, and co-ordinating, its policies to dealing with the major global imbalances.

A Constructivist Approach to EMU

Despite these promising signs, the literature on the politics of the Euro-Zone remains piecemeal and embryonic. In the context of this state of the literature the task that this book sets itself is ambitious: to provide an overview of the politics of the Euro-Zone by addressing the central political questions that are associated with it. It seeks to answer the following questions:

- how the Euro-Zone operates, the actors and institutions, how they interrelate, and the distribution of power;
- the implications for the power of the European state;
- the meaning of stability in the context of the politics of the Euro-Zone;
- the issue of legitimacy; and
- what a policy for a stable Euro-Zone would look like.

In addressing these questions the book stresses the value of the institutional approach and, in particular, of a constructivist perspective that sees the meaning of power in the Euro-Zone and the content of interests as largely a function of ideas (Wendt 1999). The