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**Europe's Experience with
Economic Policy Integration**

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Summary

The EU has turned away from its focus on administrative (de-)regulation and harmonization efforts, or institutionalized “market optimization,” towards cooperation policies that focus on “policy optimization” by centralizing monetary policy and setting strict rules for fiscal policy. Unlike earlier (and current) attempts with more limited fixed exchange rate regimes, the EMU has proved to be a strong enforcement mechanism for further market-based structural reforms without requiring further political integration.

The currently disputed fiscal restrictions, on the other hand, have the potential to cause neo-functional spillovers towards more political integration, but the EU does not seem to be moving in this direction. On the contrary, based on the current progress in structural reforms, and the EU’s general stance towards cooperative approaches with complicated schemes of checks and balances, the EU rather seems to be on the way towards an increasingly sophisticated economic union with more regional autonomy and accountability.

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Abbreviations

AC Acquis Communautaire

CAP Common Agricultural Policy

CEEC Central and Eastern European Countries

EC European Commission

ECB European Central Bank

EEC European Economic Community

EMS European Monetary System

EMU European Economic and Monetary Union

EP European Parliament

ERM European Exchange Rate Mechanism

SGP Stability and Growth Pact

1 Introduction

Europe's steps towards economic cooperation and market integration have always also been a process of political cooperation beyond (simple) economic goals. Already in the early days of the EU's development during the Coal and Steel Union, the EU did not start as a simple FTA with a basic set of intergovernmental agreements and a simple secretariat for controlling compliance with the new regulations as in the case of the WTO, ASEAN or Mercosur. Instead, the EU started with a high level of political commitment, which formed the basis for trading political against economic gains and to take advantage of international institutions on an unprecedented level. The ECSC did not only give France political control of this highly security relevant sector (Germany's war industry), it also allowed Germany to economically rebuild its industrial backbone, and implemented an entire set of institutions that already carried the seeds for future federalist developments to equilibrate this difficult political-economic equilibrium (Berger/Ritschl 1995).

According to neo-functional arguments, this step to integration in one sector would lead to "spillovers" into other sectors, i.e., from coal and steel to other sensitive or distressed sectors like atomic power, agriculture, and finally a common market that necessitates common financial institutions, a currency, fiscal harmonization and eventually common parliamentary control. Institutionalist arguments, at the same time, came to comparable results, because the fragile political-economic equilibriums would necessitate increasingly sophisticated institutions to make the (intergovernmental) commitments credible (Moravcsik 1998). Europe's common institutions therefore developed lives of their own, including their own set of bureaucratic elites, and required even more sophisticated sets of checks and balances to overcome informational deficiencies that would ultimately result in a federal-state-like structure (Eichengreen 2004).

These institutionalist and neo-functional explanations certainly provide a great deal to the understanding of the development of the EU. But they remain unconvincing to an economist for their "teleological" parts that would ultimately derive political union from economic integration. They also seem to be of limited usability.

ity as long as they remain fine-tuned to the explanation of a “unique,” “sui generis,” or path-dependent (David 1994) economic integration process in Europe. Economists therefore try to reformulate some of the results of European political integration studies in general principal-agent models, which take informational deficiencies in interregional economies into account. In these models, the principals (the EU’s citizens) support the development of sophisticated institutions on various levels to overcome problems with high information costs and difficulties in monitoring politicians, bureaucracies, and elites (their agents). But due to their liberal economic core, these models remain firmly based on the economic principals of individual self-interest and rationality. In their cost analyses, the citizens of the EU’s nation states would therefore only allow EU institutional development and involvement where economies of scale or externalities of common policies are high, so they would gain in terms of productivity from centralization, and the heterogeneity of preferences is low, so they would not lose in terms of their preferential results (Oates 1999; Alesina/Angeloni/Etro 2001). Or, in the words of Eichengreen (2004; p. 22): “In an obvious sense, citizens and governments support further integration when they see the benefits as dominating the costs. The pace of integration thus accelerates and slows with changes in the external environment and in the structure of the European economy and polity itself, changes that make themselves felt through self-interested voting and intergovernmental negotiation.” This paper follows such a liberal political economy approach for the explanation of the various steps of economic cooperation with a focus on macroeconomic policy cooperation. Such a limitation unfortunately leads to the omission of major cooperation fields, like the Common Agricultural Policy (CAP) or technical cooperation policies, which are important for the EU’s development as well (and have become policy research fields in their own right). But the restriction allows a more detailed analysis of the three fields that are at the heart of any economic and political union (or federal state): exchange rate, monetary, and fiscal policy. Finally, the focus on these key-policies might also allow rather convincing speculations about the future direction of the EU’s integration process – either towards a so-

phisticated but limited economic union or an increasingly federal-state-like political integration process.

2 EU Cooperation History – A Seemingly Straight Forward Process

The European Union started with the will for economic and political cooperation and a simple economic institution. In 1951 the European Coal and Steel Community (ECSC) was set up with six members, Belgium, West Germany, Luxembourg, France, Italy and the Netherlands, to integrate and revive continental Europe's core industries. To manage the ECSC, the Treaty of Paris established a basic set of supranational institutions: a High Authority to administrate, a Council of Ministers to legislate, a Common Assembly to formulate policy, and a Court of Justice to interpret the treaty and to resolve related disputes. After strong economic success, a series of further international treaties and treaty revisions based largely on this model led eventually to the creation of the EU.

The 1957 Treaty of Rome, establishing the European Economic Community (EEC),¹ required member countries to eliminate or revise important national laws and regulations. Beyond the elimination of all internal tariffs by July 1968, it also required that governments eliminate national regulations favoring domestic industries and cooperate in areas in which they traditionally had acted independently, such as international trade, inland transportation and many regulatory standards. A final step was the recognition of social policy as a fundamental component of economic integration, which led to the creation of the European Social Fund to enhance workers' geographic and occupational mobility. A European Defense Community, however, was rejected by the French National Assembly.

Significantly, the treaty's common market reforms did not extend to agriculture. The CAP, which was implemented in 1962 and which became the costliest and

¹ Like the ECSC, the EEC established four major governing institutions: a commission, a ministerial council, an assembly, and a court. To advise the Commission and the Council of Ministers on a broad range of social and economic policies, the treaty created an Economic and Social Committee. In 1965 members of the EEC signed the Brussels Treaty, which merged the commissions of the EEC and Euratom and the High Authority of the ECSC into a single commission. It also combined the councils of the three organizations into a common Council of Ministers. The EEC, Euratom, and the ECSC—collectively referred to as the European Communities—later became the principal institutions of the EU.

most controversial element of the EEC and later the EU was kept largely separated. It relied on state intervention to protect the living standards of farmers, to promote agricultural self-sufficiency, and to ensure a reliable supply of products at reasonable prices.

The success of the six-member EEC led Denmark, Ireland and the United Kingdom to apply for Community membership. They were finally admitted in 1972 following difficult negotiations during which France, under General de Gaulle, used its veto twice, once in 1961 and again in 1967. This first enlargement was matched by a deepening of the Community's tasks; it was given responsibility for social, regional and environmental matters.

In the early 1970s, the monetary instability that followed the end of the Bretton Woods System, aggravated by the two oil crises of 1973 and 1979, added another element of economic cooperation to the EEC. The launch of the European Monetary System (EMS) in 1979 helped stabilize exchange rates and encourage member states to pursue strict economic policies. Instead of agreeing on an integrated set of monetary rules and shielding their central banks from national influences, however, the countries chose to peg their currencies to the traditionally stability oriented monetary policy of the German Bundesbank. The result was a crawling peg system that used the Deutsche Mark (DM) as an anchor for a float against the U.S. Dollar and the rest of the world. After some success in the early 80s, however, the system became prone to devaluation crises especially from the late 80s when capital flows gravitated towards Germany.

At the same time, the Community began to play a more important role internationally, signing new agreements with the countries in the southern Mediterranean and Africa, the Caribbean and the Pacific. At the GATT agreement of Marrakech (1994), the European Union was already able to put its stamp on the negotiations by negotiating as a bloc. This added to the attraction of the common market for the EEC's neighboring countries, and the Community expanded southwards with the accession of Greece in 1981 and Spain and Portugal in 1986. These enlargements

made it imperative to implement structural programs designed to reduce the disparities in economic development between the Twelve.

The community's common external trade policy generated pressure for common foreign and development policies, and the European Political Cooperation (EPC; renamed the Common Foreign and Security Policy by the Maastricht Treaty), which consisted of regular meetings of the foreign ministers of each country from the early 70s, developed fast. The need for enhanced political representation therefore increased, and in 1979 the members of the European Parliament, who were chosen by the national parliaments before, became elected in a first direct election (every five years thereafter).

During the 80s the EEC entered a decisive phase that significantly altered its structure. From the early days the focus was on a common commercial and agricultural policy. Other policies were added as time went by, and as the need arose. But not all these changes developed in a structured way. The national interests in the Common Agricultural Policy, for example, became more and more an obstacle, while a variety of legal, technical, fiscal, and physical barriers continued to limit the free movement of goods, labor, capital, and services. Differences in national health and safety standards for consumer goods, for example, remained a potential impediment to trade. The Single European Act of 1987 therefore set out a timetable for the completion of a common market by 1992.

At the same time, however, the entire approach of forced market integration that required more and more adjustments in national policies and habits became heavily criticized – especially because it did not produce the expected growth rates anymore. The European approach of developing trade and production by building an increasingly harmonized and integrated market through common regulations, which resulted in the enormous current set of the 80,000-page *Acquis Communautaire*², seemed to have stalled in stagflation, while the EMS entered a phase of

² The major part of the *Acquis Communautaire* (community heritage; or existing set of regulations and agreements) refers to the CAP.

exchange rate turmoil, and the newly developed European institutions seemed to have become remote and poorly controlled.

The Maastricht Treaty of 1992, which created the European Union (by name), therefore targeted three major policy changes. First, it changed the EU's policy focus from market harmonization to economic policy cooperation by developing a joint policy framework for sound monetary and fiscal policy (the Maastricht Criteria) and set out a schedule for monetary and economic union with only one central bank in its middle (the European Central Bank; ECB). Secondly, it significantly increased the accountability of the EU's institutions,³ streamlined the decision making process,⁴ and gave them broader authority to actively develop policy initiatives including the ability to take proceedings against non-compliant national authorities.⁵ But it thirdly also added emphasis on regional institutions and decision making (subsidiary principle).⁶

Needless to say, such far-reaching steps met with substantial resistance in many countries.⁷ In general, however, they became very effective in reviving Europe's deadlocked structural market reforms and the political integration process. The

³ The Commission was reformed to increase its accountability to the Parliament. It got the limited right of rejection over legislation in most of the areas subject to qualified majority voting, and in a few areas, including citizenship, it was given veto power. Beginning in 1995, the term of office for commissioners, who now had to be approved by the Parliament, was lengthened to five years to correspond to the terms served by members of the Parliament. The treaty also formally incorporated the Court of Auditors, which was created in the 1970s to monitor revenue and expenditures, into the EC.

⁴ One of the most radical changes was the reform of the legislative process. The range of policies subject to qualified majority voting in the Council of Ministers was broadened.

⁵ The agreement gave the European Commission broader authority, including formal control of community policies on development, education, public health, and consumer protection and an increased role in environmental protection, social and economic cohesion, and technological research.

⁶ The treaty also created a regional committee, which served as an advisory body for commissioners and the Council of Ministers on issues relevant to subnational, regional, or local constituencies.

⁷ In Denmark, for example, voters who were worried about infringements upon their country's sovereignty defeated a referendum on the original treaty in June 1992, though a revised treaty was approved the following May. Voters in France narrowly approved the treaty in September, and in July 1993 British Prime Minister John Major was forced to call a vote of confidence in order to secure its passage. An amended version of the treaty officially took effect on November 1, 1993. Even today, discussions are far from over, and the Swedish public still refuses to joining the European Monetary Union.

EMU succeeded with the introduction of the Euro in 2002 that started to rival the U.S. Dollar as one of the major world currencies. Prices and interest rates have converged. And under the strict regime of the ECB and the SGP, structural reforms of capital and labor markets as well as tax systems firmly went on top of the political agenda of national governments.

On basis of all these changes, Austria, Finland and Sweden decided to enter the EU in 1995, while 8 Central and Eastern European Countries (CEECs) applied for accession and accepted the EU's *acquis communautaire* as basis for their transformation process. Finally, starting with Cyprus and Malta, the Mediterranean countries have now become increasingly attracted to EU accession so that Turkey has started serious efforts to follow Bulgaria and Romania as an accession country.

Today, the EU's institutions already develop or initiate more than 50% of all new (national) regulations, and the "Lisbon Process"⁸ tries to push the member states into a higher gear of structural reforms and market integration. These new European realities seem to create the necessity for further integration of policies while simplifying the EU's treaties and regulations⁹ and improving the efficiency and

⁸ In March 2000, the European Council in Lisbon set out a ten-year strategy to make the EU the world's most dynamic and competitive economy. It includes policy areas as diverse as entrepreneurship, employment, pension reform, education, macroeconomic policies, health protection and others. Already by 2004, however, it had become certain that even the mid-term targets will be missed by a very wide margin - not least because of the overload of objectives and ambitious numerical goals. Emphasis was therefore put on structural reforms in labor markets, reduction of remaining barriers and excessive regulations in the internal market (especially in services).

⁹ Although the current body of constitutional treaties, regulations and agreements, the *acquis communautaire* falls short of being a constitution, its "sui generis" development often raises the question of whether a structured and revised formal constitution would not provide a better basis for further development and enlargement of the union. At least after the current enlargement, the *acquis communautaire* has become by far too complex to serve as a sound basis, and many important aspects are not yet covered. The elimination of border controls, for example, conflicts with some national immigration, asylum, and residency policies and makes it difficult to combat crime and to apply national civil codes uniformly, thus creating the need for new Europe-wide policies.

accountability of the EU's institutions under the roof of a new European Constitution.¹⁰

¹⁰ To ensure that the EU can continue functioning efficiently with 25 or more members, its decision-making system must be streamlined and its accountability upgraded. Although the Treaty of Nice, which will be the basis of decision making in the EU until the end of 2009, lays down new rules governing the size of the EU institutions and the way they work, it is clearly not going far enough. Based on the new voting rules, it will become twice as hard to find a qualified majority in the EU25 than it was in the EU15 (see Baldwin/Widgren 2004). Furthermore, the political triangle between the European Council, the Parliament, and the Commission needs a new and effective structure, which could be best addressed under a new "constitutional treaties" that solves these problems simultaneously.

3 From Market Harmonization to Economic Policy Coordination

The historical overview of the last section provided a picture of a seemingly straightforward process of stepwise economic integration. When analyzing the distinct steps towards economic policy cooperation closer, however, it becomes clear that at least the Treaty of Maastricht defines a major turning point in the EU's integration approach. From the ECSC towards the Single Market, economic cooperation and integration focused on trade and domestic market liberalization. Economically, this approach to regional integration raised few questions during the first decades because trade liberalization in the scattered post-war European regional economies was almost certain to yield positive returns.

Furthermore, the process seemed to become even more effective because it supported domestic market liberalization of the overly regulated post-wartime economies by introducing international competition on a fast track. Even the resulting and growing set of European institutions and common regulations seemed to be necessary to coordinate and "lock in" the achieved levels of liberalization – especially because Europe's national bureaucracies could not be expected to be overly cooperative after their histories of war. Clearly, the early success of the ECSC and the EEC, which led to the accession of Denmark, Ireland and the UK in 1972, provided an excellent case for regional trade liberalization and deregulation.

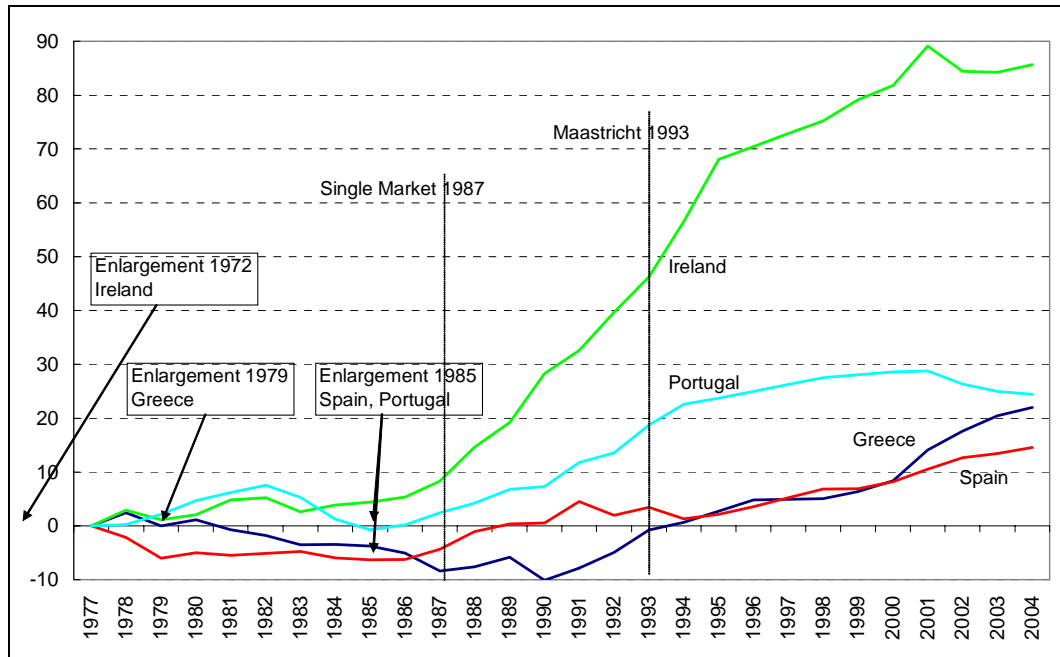
But already during the 70s, after the break down of the Bretton Woods fixed exchange rate system and during the successive oil crises, the European economic integration process seemed to run out of steam in terms of growth rates, while the EU's institutions kept growing and extending their reach into more areas of national policies. One significant extension of the EU's responsibilities towards market intervention was the introduction of the Common Agricultural Policy (CAP) in 1962, which effectively exempted agricultural products from the general FTA framework by setting domestic-currency support prices. With this, the EU's institutions did not only start to intervene directly into domestic markets, they also

extended their reach into areas where the economies of scale of centralization were low and the preferences of the EU's regions were quite heterogeneous.¹¹

As a consequence, the perception of the EU's integration as a costly, non-market oriented endeavor increased, and regional frustrations with the EU's policies started to build up (as in the case of the UK). Unfortunately, but probably not by mere coincidence, this increasingly negative evaluation of the advantage of EU membership developed at the same time when the newly joining countries did not see a positive economic impact after accession to the EU. Figure 1 demonstrates this for the relative growth rates of the least developed accession countries (with the highest potential growth chances). Not even the underdeveloped, but later highly successful, Irish economy seemed to have gained any positive growth impact from EU accession in 1972. This situation of low growth rates in the accession countries only changed with the Single European Act of 1997 and the Maastricht Treaty of 1992, which significantly speeded up market integration and provided structural development funds, as well as incentives to economic policy stabilization.

¹¹ On top of this violation of basic economic integration concepts, the CAP had further important consequences. Since it set floors for agricultural prices in domestic prices, it required exchange rate stability or constant renegotiations of EU-wide relative agricultural prices to avoid disruptive cross border arbitrage. Some authors therefore argue that the CAP became a major reason for the introduction of the EMS (Giavazzi/Giovannini 1989), and, consequently, the EMU.

Figure 1 Relative GDP per Capita Growth of Accession Counties (1977-2003)

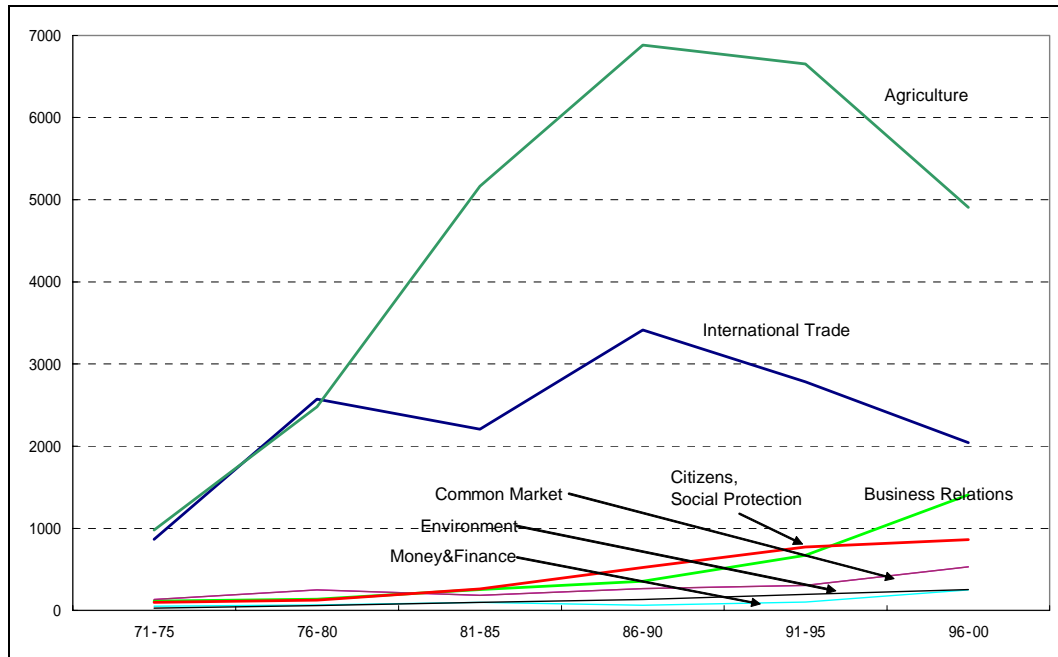


Source: EuroStat.

Note: Growth rates are plotted as PPS per capita as % of the EU15's average. Positive percentage point changes therefore mark strong growth rates because the change is on top of EU-15 growth in real per capita terms

The public's frustration about the integration process intensified during the 80s when the EU's institutions increased their output of (de-)regulatory regulation and technical market harmonization. Finally, after targeting and superseding most protectionist national rules, harmonizing 100,000 national standards, and scrapping 60 million customs and tax formalities, when the market-harmonization approach became crowned with the introduction of the Single European Market in 1993, Europe seemed to be stuck in a state of "Europe-sclerosis" for more than a decade already. Even worse, the newly developed European institutions, which were meant to efficiently complement the inefficiently diverse and scattered regional authorities, were regarded as remote, powerless, and poorly controlled, while their policies became infamous for negative "spillovers" into national markets by supporting high prices, complicated controls, dependencies on subsidies, and huge public sectors throughout Europe.

Figure 2 EU Regulations, Directives, and Decisions by Policy Domain



Source: Alesina/Angeloni/Schuknecht (2001).

Note: The numbers of legislative acts include all acts issued in the period, including those no longer in force.

The bottom line of these trade-related cooperation and institutional integration efforts during the 70s and 80s was that the EU did not find an efficient balance between institutional integration, economic cooperation, and national market reforms. National polities and bureaucracies kept growing but paralyzed themselves by negotiations on such (obscure) issues as how to harmonize the brewing of beer, and developing common standards for the size of condoms. European citizens, and their regionally focused communities, on the other hand, were left out of the race by seeing their regional identities gradually being sidelined and (national) central states growing. Many economists therefore started to question the necessity of common standards and the effectiveness of harmonization of regulations as tools for the enhancement of competition and growth (Kregel 2000).

The EC and the national European governments reacted to such criticism by gradually reforming their harmonization policies. When it became obvious in the early 80s, for example, that the prevailing detailed case-by-case approach to harmonization was too time consuming and inefficient, the process became expedited with a “new approach” that focused only on “essential requirements” for EU di-

rectives.¹² But still, the procedure time for an EU Standard was 8 years in 1999;¹³ and therefore too long for the efficient integration of the enlarged market. Standard “mutual recognition” procedures (of product regulations), on the other hand, which had become the most important tool of technical harmonization in the WTO and many non-EU regions, started to look much more attractive than the EU’s stance towards harmonization.¹⁴

In contrast to these gradually increasing internal frustrations, however, it was another, predominantly global development that required not only gradual improvements of the EU’s trade-based integration concept, but forced a major step towards macroeconomic policy cooperation instead. The break down of the Bretton Woods system left many European governments in need of stable exchange rates to secure their growing external trade and capital flows. But most European countries were not prepared to establish the necessary stability oriented monetary and fiscal policies on their own. They therefore decided to commit themselves to a gradually evolving EMS with the German mark and the German Bundesbank’s policy as an external anchor towards the dollar-dominated world market.

The system remained insufficient and unbalanced, however. Instead of stabilizing the exchange rates in the long run by focusing on reforming their monetary and

¹² Before 1985, technical harmonization was based on a case-by-case approach and contained very detailed specifications with type-approval procedures, which were difficult to implement. Under the “new approach,” community legislation became restricted to establishing the essential requirements that products must meet. These requirements fix thresholds or levels of protection for the whole of the Community in the area of health and safety.

¹³ The EU Commission reports that it takes between 24 and 75 months to draft a standard (EU Commission 1998: Technical Harmonization. <http://europa.eu.int/scadplus/leg/en/s06011.htm>).

¹⁴ Basically, the two procedures work in two different directions. While “harmonization” is implemented top-down to set standards for the national conformity assessment bodies, “mutual recognition” works bottom-up by having the domestic bodies implement standards that might be acceptable to others. Both procedures rely on mutual trust in the reliability of national conformity assessment procedures in all participating countries. But a “mutual recognition infringement” process averages only 15.5 months to be completed in the EU. The EU Commission recognizes this in its “new trade barrier transparency procedure” of 1997 by stating: “in other words, in those areas which are not subject to EU-level harmonization measures (...), mutual recognition must be the rule, and harmonization must be exceptional.”

fiscal institutions, most European countries only financed their exchange rate interventions, while negotiating for revaluations when the costs became unbearable. The Bundesbank, on the other hand, was not prepared to offer the partner countries transfers of its currency to finance their deficits. During the 80s, realignments with depreciating currencies against the German mark therefore started to become more the rule than the exception in the EMS.

Basically, as a system of policy cooperation, the EMS was not sufficient because it left too many degrees of freedom for shortsighted and purely nationally oriented monetary and fiscal policy. During the 80s, this development started to produce a major problem for the development of the Single Market, because capital flows to and from the regions started to dominate trade flows when most capital restrictions became dismantled. And since capital flows are much more sensitive to economic policy (and therefore exchange rate) related risks than trade flows, capital flows started to gravitate towards Germany's stable currency and market framework. Consequently, the less developed regions were facing increasing capital costs that limited investments, while Germany's export industry was struggling with an (periodically) appreciating German mark. For the EU's strategy of trade cooperation and market integration this resulted in a dilution of possible gains from regulatory trade improvements by economic policy related capital flows.

As a reaction to these changes in the domestic and international environment, the Maastricht Treaty on European Union, drafted in 1991 and signed in 1993, turned the approach of trade and market harmonization but economic policy diversity upside down. With the "subsidiarity" principle¹⁵ it placed emphasis on competition and diversity in market regulation, but enforced harmonization in macroeco-

¹⁵ The principle of subsidiarity was officially agreed and signed only in the 1997 Amsterdam Treaty. Effectively, its content became a major pillar of the community policy already embodied in Maastricht (Treaty on European Union, Article G, par. 5), however. The principle implies that the public authorities do not take action when citizens can do this adequately and effectively. The principle also introduces the concept of gradation, i.e. higher levels of government act only when lower levels cannot do so satisfactorily. To ensure and protect the body of already existing regulations, however, the Maastricht Treaty also stressed the already mentioned *acquis communautaire* (community heritage) as

conomic policy by introducing the “Maastricht Criteria.”¹⁶ Ironically, the endeavor to deal with these shortcomings of integration policy by departing from the long-standing track of “market optimization” to “policy optimization” started almost at the same time when the Single European Market was finally achieved in 1993.

It is most important to stress the novelty of this approach to European integration because it shifts the basis of understanding in a number of ways.

- In contrast to the trade-based approach of the European Single Market Act, which uses direct intervention, regulation, and deregulation to harmonize the historically grown set of national market regulations, the Maastricht concept of an EMU marks the start of a regime of general policy rules intended to initiate market reactions with less direct intervention. By restraining the use of private funds for public interventions it is binding the hands of national governments, and thus hopes for an enforcement of market demands for clear-cut, undistorted structural reforms.
- It defines a case where national governments, business elites, and regional voters recognized their inability to adapt fast enough to structural changes in the international environment (globalization) by purely national policy.¹⁷ They therefore support the European institutions to break through domestically anchored deadlocks on issues with wide externalities, like exchange rate policies and capital flow regulations. It is, to use a Japanese term, the European way of “gaiatsu,” or the politics of using outside pressures for internal reforms.
- Binding the hands of national governments with no (at least) equally powerful supranational replacements shifts national decision-making power to regional

a body binding existing regulations. It became an explicit objective of the Union “to maintain the *acquis communautaire* and build on it.”

¹⁶ At the intergovernmental conference in Maastricht in 1992 the entrance criteria for the EMU were set to a record of exchange-rate stability, defined as having observed the “normal” EMS margins for two years, a low rate of inflation not higher than 1 percentage point above the three best EU performers, interest rate convergence to the lower limit not beyond 2 percentage points of the three best EU performers, net new indebtedness below 3%, and total (government) debt below 60% of GDP projected on the basis of the 1997 official statistics, and to be decided in 1998.

bodies. The move to an EMU must therefore be seen as an empowerment of the regions, and not as a process of centralization. As the following sections will show, the restrictions on national monetary and fiscal policy within the EMU will increase the pressure to carry out effective structural reforms and deregulations. Regional bodies will therefore have the chance and obligation to fill this gap by competing for European capital with their own profiles of attractive infrastructures and skilled human resources.

Economists remained skeptical about the EMU and the underlying general approach of macroeconomic policy coordination and integration, however. They basically agreed that an optimum currency zone (Mundell 1961), where flexible prices, high mobility of capital and labor, and free competition guarantee a uniform transmission of supply and demand signals from and to the single central bank, would be necessary before a single currency could effectively reduce transaction costs while not disrupting regional monetary neutrality. Obviously, these conditions were not given in Europe, and the liberal position therefore joined the more regulatory oriented by asking for further policies of market harmonization before venturing into any far-reaching monetary experiments.¹⁸

But despite such criticism and the unproven character of EMU integration, the private sector – from major (business) lobbies to households who voted for the EMU in the end – decided to go forward with the Maastricht policy options (Gabel 2001; Frieden 2002). As became clear with the unlikely success of the public votes for the union after 1992, the demand for a change of national governance

¹⁷ See for example Frieden (2002) for the role of national export sector interests in EMU politics and negotiations, Gabel (2001) for the impact of various sectoral and income-level interests, and Moravcsik (1998) for intergovernmental bargaining strategies.

¹⁸ Along the same lines, the Maastricht criteria were criticized as being inconsistent because of their competing goals of exchange, monetary, financial, and fiscal stabilization.

- These goals were considered as mutually exclusive, or irresponsibly disruptive to economic growth when targeted at the same time.
- Also, the (arbitrarily) chosen target values were found to lack analytical foundation, and be insufficient to provide necessary economic harmonization.

and more open markets proved to be so widespread in Europe, that even further concentration at supra-national EU-levels seemed acceptable.

The public's opinion at the time seemed to have been right. After the start of the EMU and the introduction of the Euro, i.e., after centralizing exchange rate and monetary policy by transferring them to the ECB, the economic results have been surprisingly positive. The introduction of the Euro did not cause major domestic disruptions – despite a debate about inappropriate early price hikes in the service sector. Similarly, the Euro-Dollar exchange rate, after an initial depression of about two years, has recovered to levels beyond its initial rate. But most surprising has been the strong impact of the currency union on foreign trade. Economists had expected only a very limited positive contribution from the elimination of exchange rate uncertainty, reductions of trading costs, and better comparability of cross-border prices. But early studies (around 2002) of the impact of the EMU on intra-Euro trade found much stronger increases in trade of about 10-29% (see Pedersen 2004 for a review of studies). Newer studies now even expect that this effect will become stronger until it results in a doubling of trade among the participants (Rose 2003).

Monetary cooperation and integration therefore seems to have worked well for the EU in terms of economic stabilization and trade gains. But as a catalyst for structural market reforms, especially in financial and labor markets, the approach seems to have been much less effective. As expected, market pressures towards structural reforms have clearly been building up after monetary policy could not adjust to regionally differing inflation and growth rates anymore. But the national governments, especially in the major EMU countries, have so far preferred to rather use expansionary fiscal policies to buffer the impact, than to getting into higher gear of structural reforms. The same is unfortunately true for the “soft” cooperative approaches towards economic policy coordination that were intro-

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- Last but not least, many academics thought the treaty would be inefficient, and no union would be reached in the end, because of a lack of binding constraints and enforcements in international agreements and regulations in general.

duced together with the SGP and the Lisbon Strategy.¹⁹ The SGP has been tarnished by the non-compliant (and non-punished) German and French deficit-governments, and the Lisbon process has become stuck in an overload of ambitious and unrelated policy goals.

But despite these setbacks, the EMU's approach to economic policy cooperation still seems to be on track. The ECB has become a stable and independent institution, while exchange rate and monetary centralization has not resulted in more political integration or more centralization of other policies (or neo-functional spillovers), as was often feared (or hoped for) before the start of the EMU. Especially the smaller and the new member states, which have been moving much faster with their structural reforms, have therefore become strong supporters of the new monetary regime.

The major EU countries, on the other hand, are still struggling with structural reforms and increasing budget deficits at the same time. But they can rightfully claim that a large portion of their current deficits has been invested in labor market and other structural reforms – which would be an improvement compared to the situation before monetary and fiscal cooperation started. And even for fiscal policy cooperation the current bottom-line is therefore not entirely negative. Deficit countries still seem to feel restrained by the SGP's deficit criteria and the unusual publicity of their budgetary decision due to the peer review process. They have also made clear, however, that they are not willing to move towards more budgetary or political integration to solve their accountability problem.

As a result, the EU's mix of economic policy cooperation policies seems to have provided to more economic stability and faster structural reforms. It has not, how-

¹⁹ The Lisbon Process towards structural reform introduced a new method of open economic policy cooperation, which focused on coordination based on peer monitoring and pressure in the absence of legal instruments. For the essential employment policies, for example, the Council issues Employment Guidelines, plus Recommendations, to the member states based on Commission recommendations. The national countries then submit National Action Plans, which report on the steps taken. Finally, the Council issues the Joint Employment Report, with a detailed assessment of how the member states have responded to the recommendations of the Employment Guidelines. Based on this type of policy cooperation, an increasingly recognized array of benchmarking and score-boarding processes has been initiated.

ever, become a self-sustaining process of spiraling economic coordination attempts or a neo-functional process towards ever-closer political integration.

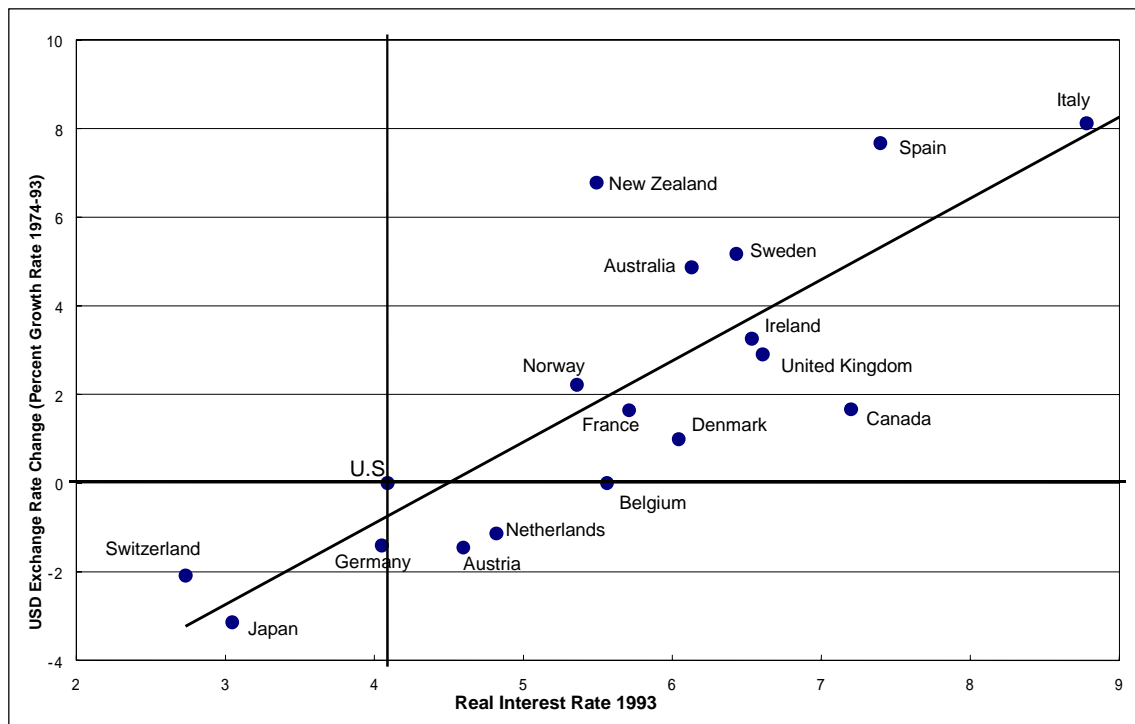
4 The EMS as an Insufficient Step to Policy Coordination

The EU's first serious attempt to macroeconomic policy coordination was a multi-lateral system of exchange rate bands against the U.S. dollar, which followed the Bretton Woods tradition of exchange rate agreements. The system, starting with agreed common bandwidths against the dollar, developed into the EMS (European Monetary System) with its fixed exchange rate mechanism in the center (ERM) during the 70s, and finally became the basis of the EMU from an exchange rate perspective. The background of this commitment was the correct analysis that after the turbulence following the breakdown of the Bretton Woods dollar-standard in 1972 only stable exchange rates would be compatible with the developing European market and would secure stable capital flows for domestic investment and growth.²⁰

Figure 3 demonstrates this basic correlation between exchange rate stability and low capital costs in terms of real interest rates for the twenty-year period before the signing of the Maastricht treaty. Any country that deviated strongly from the level of the "world currency" U.S. dollar was punished by high real interest rates.

²⁰ With the establishment of flexible exchange rates and capital flows to the U.S. dollar or competing currencies like the Japanese yen, they concluded, international capital investors would avoid keeping their capital in a country known for its depreciations. The consequences would be an increasing scarcity of capital and rising interest rates with the likelihood of further depreciations, or, even worse, a 'vicious circle' of capital flight, inflation, and depreciation. At the time, such consequences could easily be observed in South America.

Figure 3 OECD U.S. Dollar Exchange Rate Changes (1974-1993) and Real Interest Rates (1993)



Source: IMF, IFS.

Note: The percent change of the countries' USD exchange rate is calculated by dividing the 20-year nominal bilateral forex growth rate by 20.

The plotted line in the figure is the result of a simple OLS regression ($R^2: 0.73$).

The choice of a crawling peg currency regime to establish such stable exchange rates had, however, little to do with the ongoing negotiations for further trade integration or of the regular calls for further political integration. It was, as in most other regions of the world linked in one way or the other to the U.S. dollar, the result of the inability of national political bodies to deal with the consequences of international monetary independence and increasing capital flows by themselves. Most of these countries, in Europe and elsewhere, were unable to establish an independent national monetary policy, which could anchor their currencies domestically against the changes of the world's currency markets, because they could not shield their central banks from political quarrels, and were unable to protect their fiscal policies from expansionary requests.

Instead, most European countries chose to peg their currencies to the traditionally stability oriented monetary policy of the German Bundesbank, which became a forerunner for independent monetary policies with a clear-cut monetarist monetary

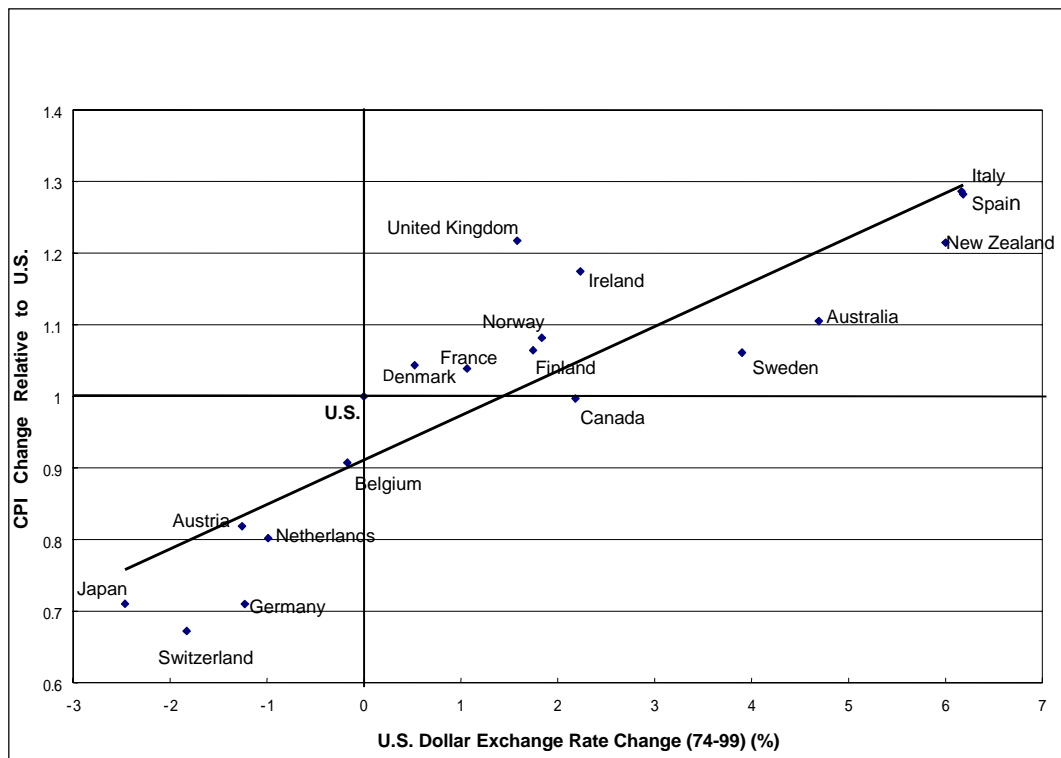
targeting concept. The result was the introduction of the EMS in 1979, which used the Deutsche Mark (DM) as an anchor for a float against the U.S. Dollar and the rest of the world.

Unfortunately, this commitment to a “fixed” exchange rate system could neither offer the hoped for monetary stability nor the targeted exchange rate stability, as Figure 4 demonstrates. This situation, which made it very clear that exchange rate stability can only be gained by (at least) successful domestic monetary stabilization, evolved because most dependent countries thought that important degrees of freedom for an independent national monetary and fiscal policy were still preserved by capital controls and exchange rate realignments – the commitment to the EMS notwithstanding.²¹ The intended ‘automatic’ monetary stabilization policy, created by effectively linking to the policy of the German Bundesbank, therefore never materialized, and inflation rates as well as the U.S. Dollar exchange rate still deviated largely within the EMS.²²

²¹ The preserved capital and exchange controls were thought to drive a wedge between domestic and international interest rates to permit the central bank to use its domestic and international assets as two fairly independent instruments, one to pursue domestic policy goals and the other for exchange-rate management (Wyplosz 1988). Furthermore, capital and exchange controls have also been necessary in the ERM to avoid speculative attacks on the system when markets anticipated a realignment (Hagen 1993).

²² Between 1974 and 2000, any country with higher inflation than the U.S. found its currency severely depreciated.

Figure 4 OECD Price and Exchange Rate Changes Relative to the U.S. (1974-2000)



Source: IMF, IFS.

Note: The plotted line in the figure is the result of a simple OLS regression (R²: 0.78).

This lack of commitment to the “rules of the game” had easily destabilized the exchange rate system already during the 80s, when growing international capital flows and the advancements of the internal market project made capital controls increasingly inefficient or even unavailable. By the early 90s, the system therefore became vulnerable to successful speculative attacks like the ones on Britain and Italy in 1992.²³

As a result, and instead of providing a final solution to exchange rate instability or monetary unreliability, the system resulted in a quite different development. It

²³ When the British pound faced speculative attacks betting on a probable devaluation after a period of monetary expansion in Britain and restrictive policy in Germany, the only way to avoid depreciation or exiting from the EMS in 1992 would have been a significant increase in interest rates. But raising interest rates through a restrictive monetary policy would have diminished income growth, which was so desperately needed after the Thatcher reforms. After some ineffective exchange rate interventions, Britain therefore opted out of the EMS in September 1992.

gave an overwhelmingly important role to the Bundesbank with the DM as a key currency in Europe. This became obvious during the crisis in 1992. Any country within the EMS would have to adapt to the stance of German monetary policy – no matter how diverse the economic situation in a country (especially after the shock of German unification) might be – or leave the system and its promise of stability.

In 1992, Britain therefore opted out of the ERM because it thought it would be able to build up a reputation for stability on its own. Based on its market reforms from the Thatcher-years in the long run, and by collecting some initial short-term gains from devaluation, it hoped to establish its currency as a counterweight to the DM. The other countries of the EMS, in contrast, did not see this option for themselves and chose to stick to the system (or promised to reenter it later) while finally adding monetary and fiscal restrictions to their national policies. On top of this, they even developed into strong supporters of the new EMU currency regime, which promised the chance to tame the might of the German central bank, while restricting the unreliability of national monetary and fiscal policies at the same time.

To sum up the EU's experience with the more or less "fixed" ERM, the main lesson became the following one: exchange rate stability can be gained only by monetary stability, which is not an automatic result of an exchange rate commitment but the cumbersome result of internal stabilization from the short to the long run.

The EU's reaction to this experience was extreme in two ways. First, it abolished all exchange rates for the willing members within the EMU. Then, it reformed the ERM (now ERM-II) by combining it with the Maastricht criteria and the SGP as a key-requirement for EMU membership for any new accession country.²⁴ With this, the ERM-II does not offer the same degrees of freedom of the old mechanism

²⁴ At first, until the enlargement of the EU, the ERM-2 remained to be an almost unchanged exchange rate mechanism with a +-15% fixed rate to the Euro – and had only Denmark as a single member.

anymore. On the contrary, the ERM-II has become the most restrictive exchange rate mechanisms anywhere.

As a consequence, the 10 accession countries of May 2004 do not only have to fix their exchange rates in the ERM-II, they also have to comply with the Maastricht Criteria, and they had to rule out capital controls and sign the SGP that restricts their fiscal policies. As long as they do not intend to play the “Swedish Card,” i.e. infringing the Maastricht Criteria deliberately, their policy options for dealing with exogenous shocks or extreme swings in their economies are therefore becoming extremely limited.

The challenges of the ERM-II for the accession countries are therefore also very different from the old member states during pre- and even post-Maastricht times. Their biggest difficulty after accession will likely be the increase of (real) appreciation pressures on their currencies. Especially real appreciations pressures are almost unavoidable for the CEECs because their productivity in the export sectors (especially manufacturing) will tend to rise faster than in the non-tradeable sectors (especially services) while the resulting increases in wages will affect both sectors rather evenly, and therefore produce inflation in the service sector.²⁵ This Balassa-Samuelson effect has been confirmed for the CEECs in many studies (see Breuss 2003, Halpren/Wyplosz 2001), and will complicate their situation after joining the ERM-2 with its strict exchange rate and inflation rate regime considerably.

The accession countries will therefore likely try to enter the EMU as soon as possible, i.e., by January 2007. And indeed are the small accessions countries, Lithuania, Estonia, and Lithuania, Slovenia, Malta, and Cyprus already negotiating to do so. Most of these countries already fulfill the Maastricht Criteria for monetary

²⁵ Since wage increases tend to be more or less the same in all sectors, inflation will be relatively higher in the non-tradeables (service) sector, especially when domestic demand in the growing economy shifts towards services after the first rush for manufactured consumer goods (especially cars) is over. The result is that the strong productivity growth in the tradeables sector, which is the target of foreign investors, will lead not only to a higher inflation rates for non-tradeables but also to a real appreciation of the exchange rate relative to the more developed trading partners that do not have such productivity gains in their tradable sectors (or high inflation rates in their non-tradable sectors).

union with some (manageable) exceptions for the budget deficit criterion and also have experience with fixed exchange rates to the Euro through currency boards.

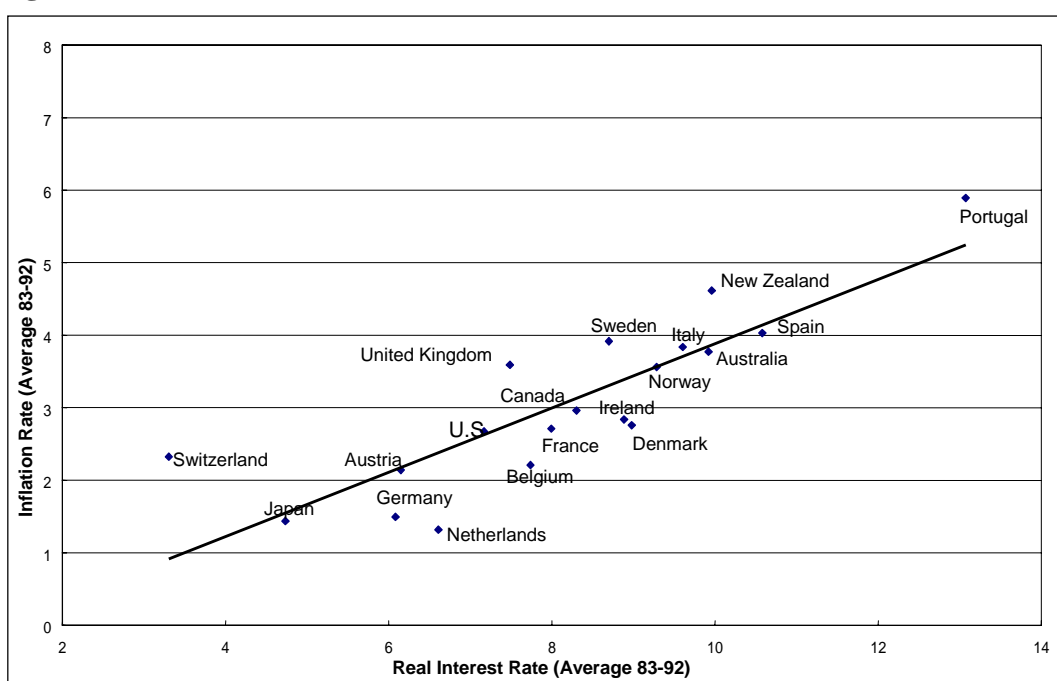
But the situation looks quite different for the big accession countries. Poland, Czech Republic, Slovakia, and Hungary are also eager to join the EMU at an early date, but are unlikely to be able to do so before 2010. These countries will be torn between the development demands for financing further transformation costs when real exchange rates start to appreciate, and the necessity to stabilize strong capital flows from the old member states and between their regions when EU-wide production networks become further rationalized. To succeed within the straightjacket of fixed exchange rates, Maastricht Criteria, and SGP they will therefore not only need to retain a strong focus on economic policy stability and structural reforms, they will also need the ongoing support of the “old” EU countries.

This support could either come in form of major structural funds to reduce the transformation costs during fiscal consolidation, or from flexibility towards the handling of the SGP and the entrance criteria for the EMU. But due to the poor experiences with stabilization policies by means of transfers and structural funds (especially in eastern Germany), the first option has already been ruled out during the accession negotiations. It is therefore much more likely that the EU will relax the SGP requirements for the fast growing accession countries and offer them early access to the EMU by showing as much flexibility in the interpretation of the Maastricht Criteria as they did when they had entered themselves (see section 5 and 6).

5 The Role of Monetary Restrictions for Policy Cooperation

By the time of the Maastricht negotiations, and after two decades of experience with hollow exchange rate agreements, most politicians and economic agencies of OECD countries had come to recognize the close link between national inflation rates, exchange rates, and the flow of international capital. Figure 5 demonstrates this link by plotting average inflation rates as an indicator for monetary stabilization, and real interest rates for financing costs during the decade till 1992.

Figure 5 OECD: Inflation and Real Interest Rates (1983-1992 Annual Average)



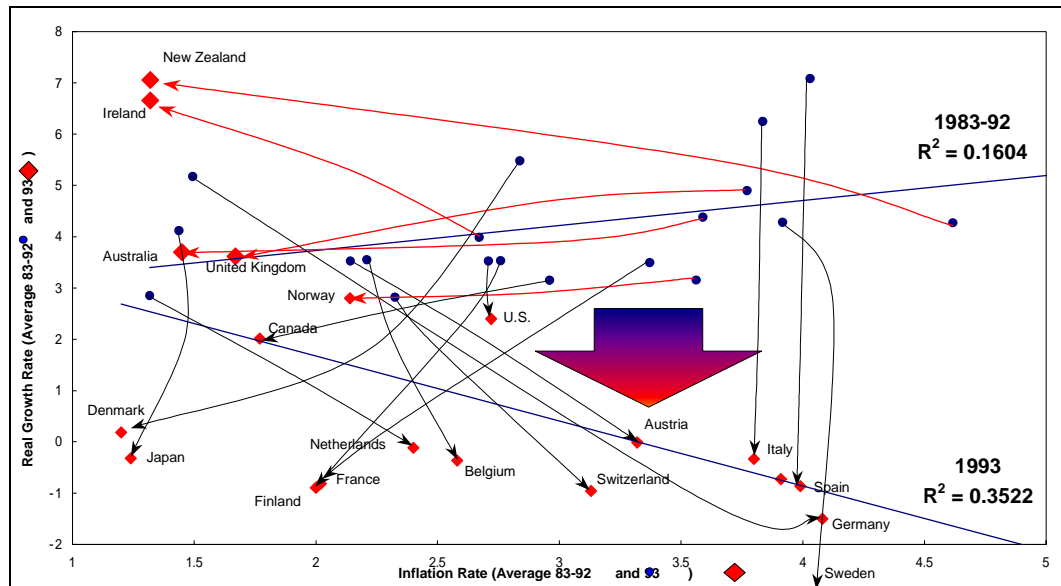
Source: IMF, IFS.

Note: The plotted line in the figure is the result of a simple OLS regression ($R^2: 0.72$).

The experience of high capital costs was not the only driving force to finally accept far-reaching monetary stabilization measures, however. During the 80s, most OECD countries also had to learn that their old Keynesian economic policies, which tried to exploit a “Phillips Curve” relationship between monetary expansion and increasing real growth rates (with only slowly reacting, “sticky” prices) became increasingly inefficient. Instead of producing “1% of inflation for 1% more

employment and growth” (the 70s’ German Chancellor Helmut Schmidt), most countries became victims of agonizing stagflation (Figure 6).

Figure 6 OECD: (Modified) Phillips Curve Relationships (1983-92 and 1993)



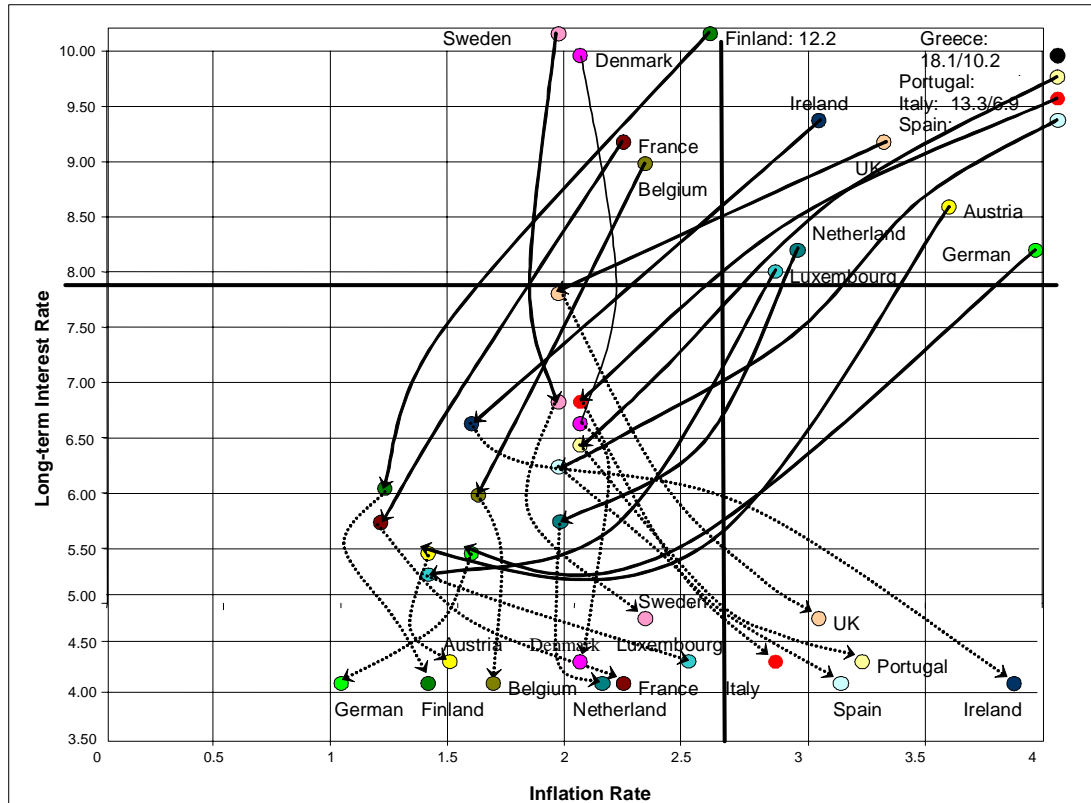
Source: IMF, IFS.

Note: The plotted lines in the figure are the results of simple OLS regressions for the two periods (1983-92 R^2 : 0.16; 1993 R^2 : 0.35).

As Figure 6 demonstrates, the link – if any – between expansionary monetary policy, as evident in higher inflation rates, and real growth rates was already extremely weak during the 80s (see the upper estimated correlation). By 1993, however, the relationship – if any – broke down completely, or even reversed to a high chance for low growth in countries with high inflation rates (the lower correlation estimate). At the time, most OECD countries already experienced lower or even negative growth with high or even increasing inflation rates. The few successful countries, as diverse as England, Canada, and New Zealand, on the other hand, which brought down inflation with stable or even increasing growth rates, were countries that had already initiated serious structural reforms, and ventured into transparency enhancing stability oriented monetary policies like inflation targeting. By means of their attractive economic models they managed to mobilize enough resources to gain high growth rates without pushing real interest to unbearable heights.

Given these experiences and examples, and because the EMS had already severely limited the degrees of freedom for national monetary policies, the monetary “Maastricht Criteria” were met by almost all candidates at the time of the May 1998 beauty contest for entering the EMU (Figure 7).

Figure 7 Convergence Criteria: Inflation and Interest Rates 1992, 1997 and 2003



Source: IMF, IFS; EuroStat.

Note: The values for long-term interest rates and inflation in 2000 are: Belgium: 4.2/1.5; France: 4.1/2.2; Spain: 4.1/3.1; Italy: 4.2/2.8; Germany: 4.1/1.0; Netherlands: 4.1/2.2; Finland: 4.1/1.3; Sweden: 4.6/2.3.

The convergence of inflation and long-term interest rates during the five years between 1992 and 1997 is impressive indeed, and it underlines the strong determination of most countries that signed the Maastricht Agreement. To regain some more freedom in terms of monetary decision-making, and to become attractive locations for global capital flows again, the 15 candidates – except Greece – drew very close to the three countries with the lowest interest and inflation rates (7.9% long-term interest rate and 2.6% inflation at the time).

After entering the Monetary Union on January 1, 1999, all national central banks became members of the European System of Central Banks (ESCB). They lost their competence to define national monetary policies, and to set their individual interest rate and quantity targets. But they also gained voting power on common European policy issues by sending their central bank presidents as board members to the new institution.

In contrast to the fears (and hopes) before the start of the Union, the impact of this shift in monetary competence was much more limited than initially expected. As already explained above, real monetary and exchange rate steering powers in Europe became centered in Frankfurt at the German Bundesbank long before. Most EMU countries therefore lost little, but gained by exchanging their low degree of national monetary control with some voting power on decisions concerning the Euro. The same is true for exchange rate policy (Engel 2000). The limited chances for each country to intervene in the foreign exchange market (often on the initiative of the Bundesbank or required by EMS regulations) were traded for the participation in an international key currency. This gain, however, is limited by the independence of the ECB, which is unlikely to fall victim to the interests of any single member country.²⁶

On the contrary, based on the contract of Maastricht, the ECB has become a truly independent agency with clear-cut objectives that cannot easily be influenced by single governments or limited coalitions in the Council. The current problem of monetary policy in Europe therefore rather is that the ECB has almost no chance to react to specific national (or regional) inflationary developments, as has been correctly predicted by the proponents of the theory of optimum currency zones. Furthermore, the ECB also seems to be reluctant and slow to react when bold policy signals might be required at times of exogenous shocks – as in the 2004 case

²⁶ Rather unexpectedly, the policy of the ECB during the first years seems to be too strict for the German economy, more or less fitting to the surrounding smaller countries, and probably too expansionary for countries at the periphery (like Ireland). The likely concentration of ECB policy on the major countries (like Germany) seems not to have materialized.

of rapidly increasing oil prices while the economy remained at the fringes of recession. Often, the ECB is therefore claimed to be more of an institutionalized “monetary policy rule” than a central bank (that is able act at its own discretion during extraordinary at times).²⁷

The result is, that due to the otherwise still quite different economic conditions in the countries of the Euro Area, inflation rates started to deviate again (see Figure 7). As has been argued throughout this paper, this seemingly frustrating result should be interpreted as a foreseeable consequence of a cooperation policy that sets a restrictive macroeconomic framework to induce structural market reforms on national and regional levels by freeing market forces and increasing competitive pressure on national regulators.

But although regional differences have been building up fast, structural reforms in the national (financial) markets have been slow. The problem started with the national central banks, which have only very recently started to reorganize in line with their new, much more limited duties as regional central banks (i.e., shrinking in size).²⁸ This persistence of the national central banks is not only due to an institutional reluctance to downsizing, though. Within the heavily banking oriented Euro Area, the whole body of specific and locally developed banking, financial,

²⁷ One reason for this limited (not necessarily negative) role of the ECB is that its policy needs to be very cautious as long as it cannot rely on a proven bureaucratic track record that allows market players to interpret its signals or trust its (unexpected) judgments. More importantly, however, it seems to be a problem of its governance structure. Due to the ESCB’s intergovernmental setup, the ECB is governed by a rather large board of directors from all member states. After enlargement, also the governors of the acceding countries’ central banks will attend meetings of the General Council of the ECB as observers, and later join the main decision-making body, the Governing Council, when they adopt the euro. To accomplish this, the ECB ventured into a governance reform that anxiously tries to protect its independency by constructing a multi-layered decision making board that would not allow for dominating powers of single country board members. At the same time, they tried to convince the member states that they will retain sufficient democratic control over the future course of the ECB’s development by involving the national governors as much as possible. The resulting complicated rotation scheme now rather seems to result in technical inefficiency or even structural paralysis than in securing the necessary decisiveness for the monetary steering of a major economy.

²⁸ The ECB, at the same time, has been building up its capacities only slowly because any step towards centralization in Frankfurt is met with resistance from the national central banks in ESCB.

and capital market regulations and supervision procedures remained almost unaffected by the changeover to the ECB. The central banks, often at the very center of these regulatory networks, are therefore still busily managing their economies in terms of regulatory control and guidance.

The same is true for other financial reforms. Only as recently as the Stockholm summit in March 2001, the first steps in the direction of a more unified financial market in Europe have been taken, and even the most adventurous plans are not expected to involve any major changes before 2005 (see Lamfalussy 2001; Economic Policy Committee 2004).²⁹ In the current state of affairs, few private market players therefore have an incentive to restructure their business on a European level because they are still bound by only slowly changing national regulations.

The EU's financial ministers, in turn, try to make up for the gap with old-fashioned debt-financing strategies that were thought to be ruled out by the Maastricht Treaty's debt and deficit criteria and the SGP. The EU's future course of fiscal policies and the decisions about the beleaguered SGP will therefore become decisive factors for the (relative) success or failure of the monetary union and its future course towards more (political) centralization or economic regionalization.

²⁹ In its 2004 Annual Report on Structural Reform, the Economic Policy Committee (2004) comments: "While most countries have financial markets that function tolerably well, markets are still segmented."

6 Fiscal Restrictions as a Decisive Step to Policy Integration

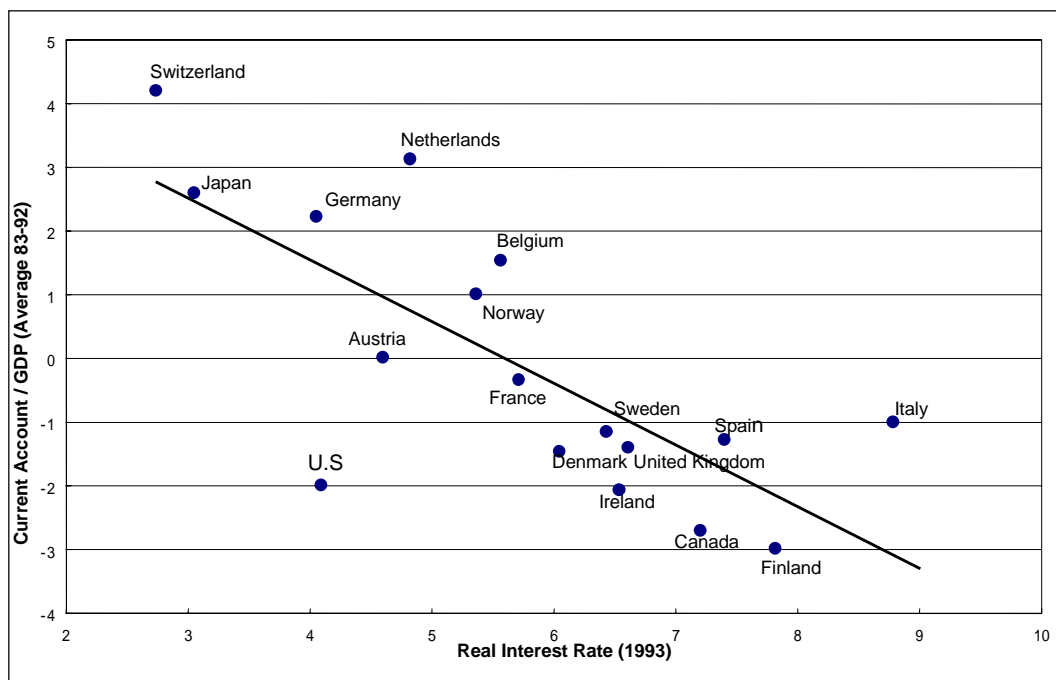
At Maastricht, the “fiscal criteria” produced the most interest and controversy because they constituted the real departure from the EMS in the short run, and seemed to be only indirectly related to the monetary core of the agreement. Furthermore, most governments were well aware that they would have major difficulties in passing an austere fiscal barrier, and the weaker ones suspected the arbitrarily chosen levels of 3% budget deficit and 60% public debt to GDP to be more of a tool for politically inspired sorting, than for establishing broadly accepted standards for “best policy.”

After considerable struggles fiscal austerity was finally recognized as a prerequisite for an independent monetary policy at the new central bank, which would otherwise easily fall victim to cash-starved national governments. The acceptance of the fiscal criteria went far beyond simple monetary arguments, however, because most European countries had already recognized that they had lost high degrees of fiscal independence to financial decisions of international investors on the world's capital markets, and that only a tamed public sector could help to regain their international competitiveness in general.

An important “eye opener” for such insights was the French “Mitterrand experiment” of 1981. Against the background of a restrictive monetary policy in Germany after 1980, the French government under Francois Mitterrand decided to lift the economy out of recession unilaterally by trying expansionary demand management. But although the government could still rely on some capital controls at the time, the capital and the current account quickly deteriorated, the exchange rate came under severe pressure, and inflation was shooting up. Already by late 1982 the French government was forced to realize that a more restrictive policy along German lines was unavoidable. If nothing changed, France would have to leave the EMS due to the high pressure on its exchange rate. Also, with its policy stance out of sync with the rest of Europe, the government realized that the current account deficit turned capital flows against France. A development, which would finally materialize in higher real interest rates and crowding out of the public ef-

forts to set the economy on an expansionary course. Most importantly, however, the government realized that this would happen inside or outside the EMS (Figure 8).³⁰

Figure 8 OECD: Current Account (1985-1994 Average) and Real Interest Rates (1993)



Source: IMF, IFS.

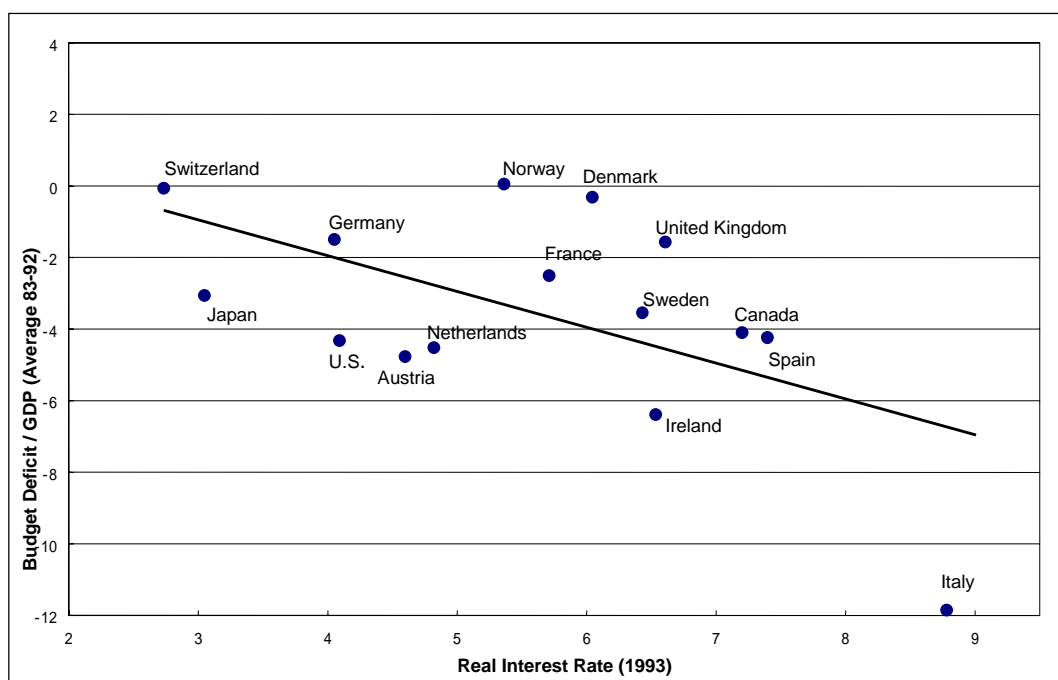
Note: The plotted line in the figure is the result of a simple OLS regression ($R^2: 0.56$).

Figure 8 demonstrates the close relationship between current account deficits and the real interest rate for the decade after the Mitterrand experiment and before the Maastricht Agreement. The (almost) only exception in this picture is the U.S., which was able to maintain low interest rates despite a high current account deficit because of its role as the provider of the international key-currency, and its by far most attractive capital markets. All other countries with high prices and demand beyond their resources in the long-run were punished by much higher real interest rates.

³⁰ Thus, the relevant political question was not whether or not a correction should take place at all, but whether or not it should occur inside or outside the EMS. A review of the case in the OECD (1988) argues that, based on the French experience in the 1970s, the authori-

The current account as an indicator for a national expansion out of sync with the developments of the countries' major trading partners – regardless of the source of the expansion – presents only half the picture, however. Especially in countries where monetary policy is not independent and unreliable, but also in situations when it is bound by outside sources, as in the EMS or – even stronger – within the EMU, fiscal policy and the budget deficit become indicators and sources of interest rate and exchange rate developments (see Figure 9).

Figure 9 OECD: Fiscal Deficits (1983-1992 Average) and Real Interest Rates (1993)



Source: IMF, IFS.

Note: The plotted line in the figure is the result of a simple OLS regression ($R^2: 0.32$).

The link between budget deficits and capital costs is not very close, even for countries with public sectors the size of Europe. But the already mentioned fiscal policy disasters of the 80s underlined its significance, and most countries understood that fiscal policy would grow in importance within an EMU. When monetary policy and the exchange rate are bound in one way or the other, fiscal and budgetary policies become the most important policy tools. Many commentators of the

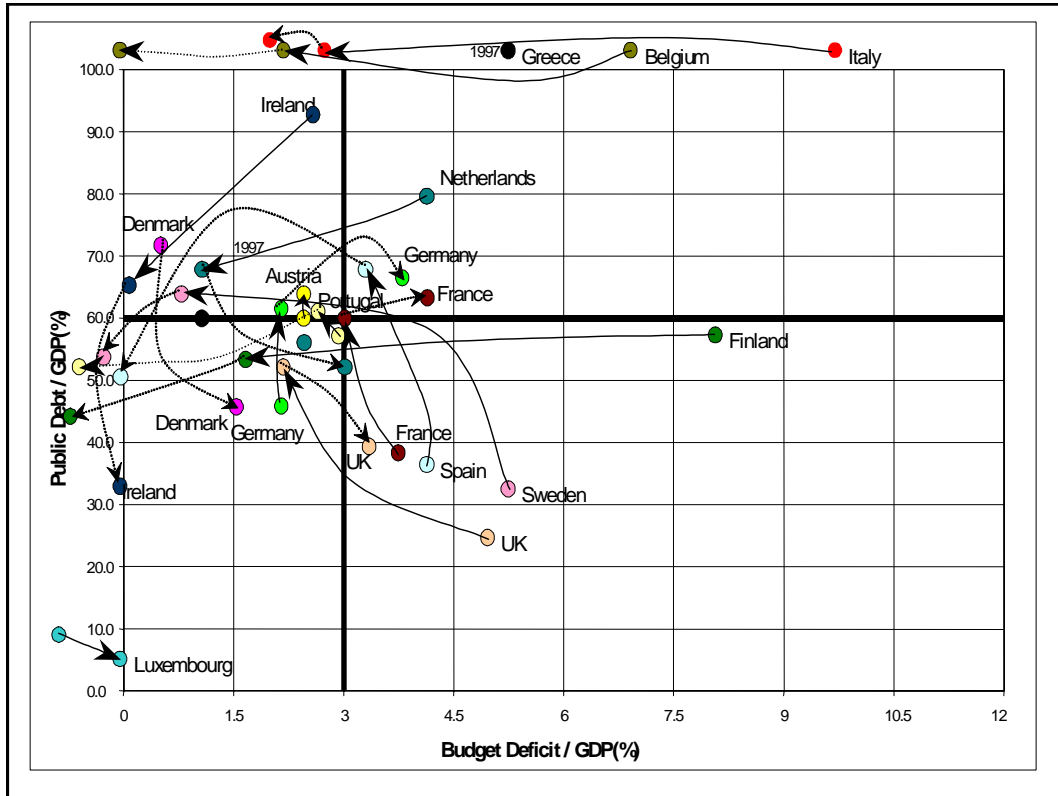
ties expected adjustment under a flexible exchange rate to be even more harmful than ad-

Maastricht Agreement therefore claimed the introduction of additional fiscal goals to be optimistic at least, or outright contradictory at their extremes. They therefore recommended deleting the fiscal criteria from the Maastricht agenda (De Grauwe 1994).

However, to become an efficient policy tool, fiscal policy had to be freed from paralyzing skyrocketing public debt, and from the many demands of the national networks of vested interests (Sapir 2003). Based on this insight, the sincerity with which most candidates followed a fiscal austerity course during the Maastricht regime became one of the most remarkable developments of economic policy in Europe during the 90s. Many countries such as Germany, France, Austria, Portugal, Spain, and the especially troubled Italy undertook considerable efforts, and even ventured into special measures like window-dressing and one-time “Union-taxes” to reach the goal for entering the Union.

Figure 10 shows the race below the 3% budget deficit line until 1997 (straight line), but also demonstrates that most countries were unable to reach their debt-target at the same time.

Figure 10 EMU Convergence Criteria: Debt and Deficit 1992, 1997, and 2003



Source: IMF, IFS; EuroStat.

Note: The values for deficits and debts in 2003 are: Belgium: 0.2/100; France: -4.1/63; Spain: 0.3/51; Italy: -2.4/106; Germany: -3.9/64; Netherlands: -3.0/55; Finland: 2.3/45; Portugal: -2.8/59; Sweden: 0.7/52; Denmark: -1.5/45; Greece: -1.7/102; Ireland: 0.2/32; Luxembourg: -0.1/4.9; Austria: -1.1/65.

Obviously, in 1997 most critics of the Maastricht Criteria were right: not all entrance criteria could be reached by most member states. Given the five targets, exchange rate stability, reduction of inflation rates, interest rate convergence, and low deficit and debt levels, it was rather clear from the beginning that these goals could only be reached under the most favorable conditions, which hardly prevailed because of external factors like the costs of German unification and crises in Russia. Having their exchange rates bound within a tunnel, and their monetary policies on a restrictive course, most countries therefore used their budgets to buffer the impact, but remained able to set their 1997 deficits right into the target zone. The goal that became sacrificed during the run for the EMU was therefore public debt, and, at the time of the decisions for “Ins and Outs,” even countries with ex-

treme public debts of over 120 percent of GDP like Belgium and Italy were allowed to enter the union based on their convergence records for the other targets.

Due to concerns about these remaining high levels of debt, lacking institutional constraints towards further fiscal austerity after entering the EMU, and German second thoughts before finally giving up its proven currency, the EU member states, in 1 January 1999, added a Stability and Growth Pact to the Maastricht regulations. The pact stipulated that the member states have to ensure a medium-term budgetary position close to balance or in surplus. Excessive Deficit Procedures under the guidance of the EC, which might include sanctions (non-interest bearing deposits and later fines), can be imposed on the Euro Area member states that fail to implement sufficient measures to adjust a budget deficit exceeding 3% of GDP.

Furthermore, to control the sustainability of such measures in a peer review process (similar to the Lisbon process), and to trigger possible Excessive Deficit Procedures, all members states have to prepare Stability Programs (euro members) or Convergence Programs (non-euro member). These programs must detail budgetary plans for the next three years and have to present consolidation measures for excessive deficits. Based on these programs, the EC prepares each third year Broad Economic Policy Guidelines, which detail the EU's economic policy strategy including country-specific guidelines.³¹ Should a member state fail to observe the guidelines, the Ministers of Economic Affairs and Finance may issue a recommendation (although no sanctions can be imposed as in the case of the Excessive Deficit Procedure).

For the first years after passing the 1997 Maastricht deadline for Monetary Union, the member states seemed to have accepted the SGP's idea of a rule-based framework for fiscal policy coordination with an emphasis on stability oriented "auto-

³¹ The guidelines have become integrated with the Lisbon Strategy in the meantime. They focus on: growth and stability-oriented macroeconomic policies; economic reforms to raise Europe's growth potential; and strengthening sustainability.

matic stabilizers”³² to dampen business cycles. Even though a great deal of “artistic accounting” efforts was mobilized to reach the goal of EMU membership, budget deficits did therefore not just snatch back to higher levels immediately after 1997 (see Figure 10). But already the economic slowdown after 2000 forced the UK, the Netherlands, Greece, and most prominently Germany and France to first exceed the 3% budget deficit limit for one year, and then lead to clear-cut non-compliance with the pact by the two biggest euro-member states when they did not adjust their budgets for a second, and in the mean time, a likely third year.

This situation triggered a crisis for the SGP, when the EcoFin Council, after intensive lobbying, did not follow EC recommendations for (softened) Excessive Deficit Procedures, but settled for non-binding recommendations instead. The European Commission therefore brought the procedure before the European Court, which decided that an EC recommendation cannot simply be overruled by the EcoFin Council during an Excessive Deficit Procedure. So the entire process is now still up in the air because the enforcement still depends on the acceptance and commitment of the individual member states. And such a commitment is clearly not given today anymore.

The two biggest member states, Germany and France, claim special fiscal situations due to necessary but costly structural reforms, an exogenous shock from poor international growth rates and a deflationary monetary environment in Germany. The economically smallest countries, on the other hand, the new accession countries, which still face high costs for restructuring and infrastructure investments, have no interest in a restrictive SGP anyway – which is a source of concern for the major member states in turn. So the small and midsize western European countries, which have little problems with the SGP due to their early restructuring and their simpler tax structures, remain the sole supporters - although more in principal than in essence. The current stance towards fiscal cooperation policies has

³² During phases of (low) strong growth, (de-) increasing tax income and (higher) lower government expenditure for social security work anti-cyclical without direct government intervention.

therefore become a move towards rescuing the SGP by reforming it with more flexible targets and effective procedures.

Most of these proposals³³ focus on a more flexible approach to the strict 3% rule, which is not only considered to be too rigorous and inflexible, but also to be too asymmetrically strict during recessions (Buiter/Grafe 2003) in general, and for the transformation countries specifically. The reforms therefore try to improve the working of the automatic stabilizer concept by stressing cyclical adjusted budgets that allow more leeway during recessions but also require serious consolidation during phases of growth. They also try to give Ecofin and the Commission more discretion for taking debt-levels and long-term outlooks of fiscal positions into account (Pisani-Ferry 2002). Some proposals even recommend the exclusion of public investments from the budget deficits (“golden rule”) so that especially the new member states would gain more flexibility for necessary infrastructure measures (Blanchard/Giavazzi 2004).

It is unlikely, however, that such rather complex improvements of numerical targets will solve the EU’s fiscal policy cooperation dilemma. The EU’s history is already littered with such incomplete and directionless cooperation policies under the ERM, the CAP, or the EU’s earlier stance towards excessive harmonization. The experience of these earlier cases was that complex, basically unenforceable rules rather shift the attention of bureaucracies towards possible free rider situations and lead to endless readjustments. This, at the same time, diverts governments from the more efficient focusing on structural market reforms, and would therefore violate the intentions of the Maastricht Treaty and the Lisbon process.³⁴

³³ Many recommendations have already found their way into a report adopted by the Ecofin Council on “Strengthening the co-ordination of budgetary policies.”

³⁴ It also needs to be noted that if fiscal rules become strictly enforced, national governments would try to control or influence fiscal decisions through the Council of Ministers (as they already do today). In another step, after becoming used to operating more budget decisions through the Council, they might then become interested in shifting more funds from their national budgets to the EU budget. Finally, the EU’s public will need to decide if they want to follow up on such neo-functional spillovers by upgrading the EU’s fiscal institutions with more accountability through control by the EP, or if they want take the costly step of turning the clock back.

Furthermore, even if such adjustments would make commitment to the rule-based approach to fiscal cooperation easier and more consistent, they do not solve the problem of limited accountability if (major) countries keep breaking even the relaxed rules and start to harm the Euro Area's stability reputation. Due to a lack of a credible sanction mechanism, non-compliant countries clearly cannot be stopped with current procedures.

European think tanks (CEPR and CESifo) therefore recommend scrapping the strict rules entirely and replacing them with an independent "sustainability council" of experts that would be appointed by the European Parliament. This institution could have the sole right to judge whether countries were going too far into the red – based on a flexible country specific approach to total public debt and yearly deficits. Or it could pass excessive deficit procedures to the European Court of Justice.

The problem with such a centralization-oriented approach is not only that the EU governments seem to be unwilling to give up control of fiscal policy decisions. It would also require a commitment towards more political integration because any top-down enforcement of budget decisions would always affect Europe's regionally diverse fiscal institutions and distributional decisions directly. Further steps towards more democratic accountability and control of the new institutions, either through the Council or the EP, would therefore only be a matter of time. This, in turn, would pave the ground for further budgetary transfers to the EU - a development, which runs against recent fiscal trends towards more (sub-nation state) regional autonomy.

From an economic point of view, both attempts to reform (i.e., initiating complex but enforced rules vs. institutional centralization) are rather undesirable because they indirectly or even directly lead to further political integration and centralization. This means that regionally heterogeneous preferences would become ruled by more centralized decisions while gains from more efficient decision-making are highly questionable – especially after the enlargement of the EU to 25 very diverse members. On the contrary, due to better availability of information, im-

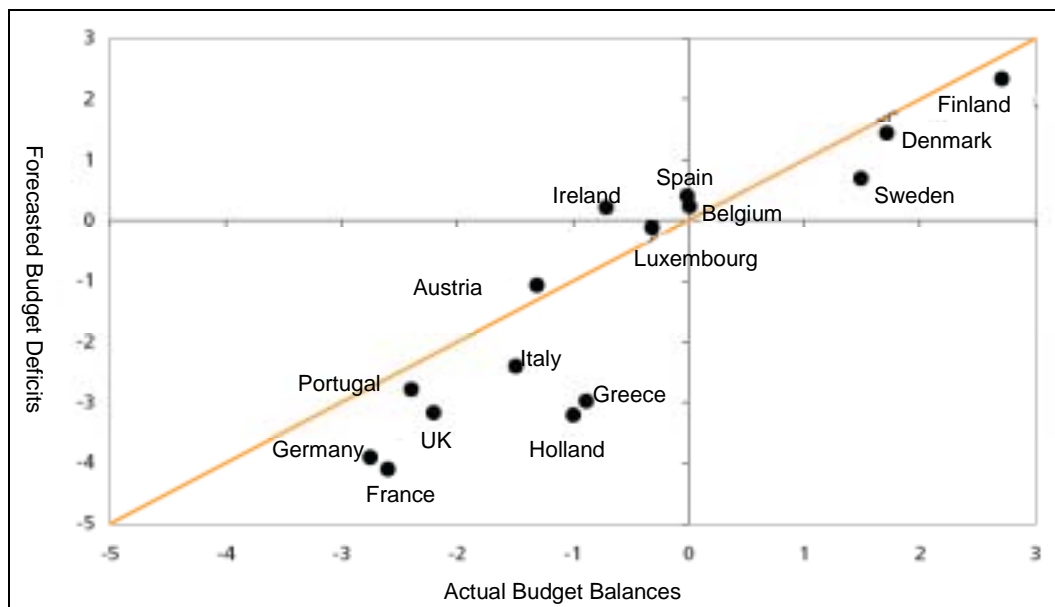
proving market mechanisms, less national government intervention, and emancipating regional governments, it would be better to shift more fiscal powers to the regions where the EU's citizens are in a better position to steer their representatives according to their preferences.

The most likely solution to the current SGP crisis will therefore be a move towards a more or less complicated relaxation of the rules of the SGP until they become acceptable to the EU's governments again. Although this also means that the pact would become non-binding (or meaningless in a strict sense), this more liberal approach would hardly raise major risks for economic stability in Europe.

The ECB has already demonstrated that it is not easily influenced even by fiscally non-compliant major member states. Stability also remains protected by the "no bail-out clause" (the agreement that no government failing to repay its public debt will be bailed out by the central bank or other member governments). This "no bail-out" clause discourages international investors to buy into excessive new government debts, and will enforce the tendency of international capital markets to evaluate national debts and policies as they evaluate the debts and policies of major corporations. Based on the market mechanism, the fine for excessive deficits simply becomes an increasing interest rate on the governments' bonds.

Furthermore, the simple reform approach would upgrade the cooperative peer-review process of the yearly Stability Programs and the longer term Economic Policy Guidelines to a central cooperation instrument. This does not seem to be problematic either because the underlying national government budget forecasts have not been exceptionally unreliable even during the difficult year of 2003 (see Figure 11).

Figure 11 EU Actual and Forecasted Budget Balances 2003



Source: Jensen/Larsen (2004)

Note: Forecasts of the member states' stability and convergence programs at the beginning of 2003.

In 2003, most member states were too optimistic about the development of their budgets, and only the countries with balanced budgets managed to give appropriate forecasts. But this seems to have been more a problem of underestimating the impact of an extended period of low growth on unbalanced budgets, than an intentional bias or institutional neglect. This impression is backed up by a study of Strauch, Hallerberg and von Hagen (2004), who found that budget forecasts from 1991 to 2002 (and especially 1999-2002) were generally on the same accuracy level as forecasts of the IMF or the EC. Only Germany, Portugal and Italy seemed to have systematically overestimated growth, while Ireland, Sweden, and the UK underestimated it. In the longer term, such a result hardly poses a major threat to the soft parts of the SGP, and could likely become corrected by continuous peer pressure.

If necessary, the cooperative approach could also be upgraded by shifting the focus from transitory fiscal outcomes to fundamental fiscal institutions, as Eichengreen (2003) recommends. In his proposal, the EU would design an index of institutional reform (monitored by a committee) with upgrades for countries that im-

plemented advanced structural reforms. Special points would be given for pension, unemployment, and revenue sharing reforms. The countries with strong institutions would become exempt from the SGP's guidelines, because they would be at little risk of falling into vicious deficit cycles. The other countries would remain subject to fiscal restrictions and peer pressures; but under this proposal they would have a stronger incentive to focus on structural reform instead of (comparatively) directionless deficit fighting.

Finally, the bottom-line of the EU's experience with simple fiscal rules and advanced reform proposals is that "binding the hands of governments" indeed increased market pressures for structural reforms. But the approach only worked well for exchange rate and monetary policies. For fiscal policies it still seems to be beyond the interests and realistic adjustment reactions of national governments. In the major member states with complex fiscal and budgetary systems, the adjustment speed to the new environment remained to be much slower than the rules could allow. In the new member states, on the other hand, the need to finance further transformation costs will likely become a major obstacle to compliance for years to come. Most member states will therefore resist early steps towards stricter enforcement of the fiscal rules, or any type of related political integration and centralization initiatives. Even if fiscal policy cooperation becomes upgraded by a more or less complicated system of checks and balances (as it has become a tradition in European institution building), the system will likely remain a much more liberal attempt to fiscal cooperation than was originally planned.

7 Conclusion

The EU's experience with economic policy integration has basically yielded the following main results.

First, cooperation policies towards market harmonization are only efficient as far as they contribute to a common level of understanding and trust. Beyond such basic levels of market integration, further administrative harmonization attempts only result in bureaucratic costs and public frustration. During the 80s, the EU therefore turned away from heavy-handed harmonization efforts towards more market competition and (simple) mutual recognition of standards. Instead of further relying on cooperation policies towards institutional "market optimization," they started to focus on "policy optimization" by centralizing monetary policy and setting strict rules for fiscal policy.

Second, the limited economic policy restrictions and coordination instruments in earlier and current fixed exchange rate frameworks (EMS and ERM-II) proved not to be sufficient for strategies of "policy optimization" of stability oriented monetary and fiscal policies in the longer run. The system either retains too many degrees of freedom to work reliably, as it was the case of the EMS in the 80s, or it becomes too restrictive to remain acceptable for the member states, as it will likely become true in the case of the ERM-II for the new member states.

Third, monetary centralization seems to work well even without further political integration. The market result of centralized monetary policy was that interest rates converged Europe-wide, while inflation rates started to diverge in line with the different growth dynamics of the regions. The resulting differences in real interest rates now give significant boosts to those dynamic regions that did not need to rely on specific monetary policies. Delays in structural reforms, as in the case of many regions in Germany, on the other hand, were followed by disinflation and punishing high real interest rates. Politically, monetary integration also proceeded well with a rather independent ECB that builds its accountability on a combination of bureaucratic track records, rule-based behavior, and only limited control from governments. If anything, the ECB's policy would now further gain from less in-

tergovernmental involvement and improved flexibility through a smaller board of directors.

Fourth, in a monetary union, fiscal restrictions have the potential to cause neo-functional spillovers towards more political integration, but the current economic cooperation process in the EU does not seem to be moving in this direction. The strictly defined fiscal rules of the SGP, which might have caused a future reliance on higher EU-wide budgets and more structural funds, have failed already, and more institutional enforcement does not seem to be supported by a decisive majority of member states. On the contrary, based on the current progress in structural reforms and the EU's general stance towards cooperative approaches with complicated schemes of checks and balances, it is much more likely that the EU will keep relying on rather flexible intergovernmental peer review instruments (as in the case of the Lisbon process).

Finally, after stabilizing exchange rate and monetary policies, while increasing market pressures for more structural reforms, the EU does not seem to be on the way towards a more centralized "United States of Europe." Even if the EU's governments and citizens would choose more political integration and centralization to improve internal security or external foreign policy, this would not be a result of economic needs or neo-functional spillovers. From an economic point of view, the EU rather seems to be on the way towards an increasingly sophisticated economic union with more regional autonomy and accountability.

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