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Financial Power & Monetary Regionalism

The Political Economy of European Monetary Union after the end of the
Bretton Woods Financial System

Minor Dissertation in partial fulfilment of the requirements for the award of the
degree Master of Social Sciences in International Relations

Masters Candidate

Fabio De Masi (BHon Economics, University of Hamburg)

Supervisor

Prof. Robert Schrire

Declaration

*This work has not been previously submitted in whole, or in part, for the award of any
degree. It is my own work. Each significant contribution to, and quotation in, this
dissertation from the work, or works, of other people has been attributed, and has been
cited and referenced.*

Berlin, 8th of September 2009

Signed by candidate

Fabio De Masi

Student no. DMSFAB001

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Abstract

The dissertation discusses financial power and monetary regionalism against the background of the European Monetary Union. It examines the role of financial power in states' decisions to sacrifice their national monetary policy in favour of a monetary union. The level of analysis is the nation state.

The post-Bretton Woods financial system and the globalisation of financial markets have pronounced the unequal distribution of financial power across nation states. The majority of member countries in the eurozone with previously little financial power have chosen monetary integration as a response to globalisation. On the other hand, countries with substantial financial power such as Germany agreed to monetary integration for the sake of a mercantilist economic agenda and broader political goals.

Thus, the central theoretical conflict of regionalism, whether the latter is a response to or part of globalisation, can be reconciled. However, tensions arise from hegemonic dominance and the different interests of nation states in pursuing monetary regionalism. Further research should focus on the attainability of symmetric regional integration and identify how domestic interest groups influence national approaches to monetary regionalism.

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Section I

Theory & Concept

University of Cape Town

1. Introduction

Regionalism refers to states substituting a regional order for domains of national sovereignty and to the political ideology of regionalism. (Boughey 2003: 39). *Monetary regionalism* labels regional cooperation in monetary and fiscal affairs (Dieter & Higgot 2003: 430-455).

Regionalism is understood as either a response to or a part of globalisation (Hettne 1999: 1). The quality of globalisation and its impact on the nation state are disputed (Gilpin 2001: 362-376). However, a consensus has emerged that financial markets are the most globalised domains of the international economy¹ (Keohane & Nye 2000: 110). European monetary integration is considered the most advanced real world example of economic integration (El-Agraa 1997: 2). Hence, monetary regionalism and its role within the process of economic globalisation deserve special attention.

The roots of European integration are controversial. Some authors argue that European regionalisation is predominantly market-driven (Mattli 1999) while others stress the political nature of the process (Gilpin 2001: 343). The paper adheres to an eclectic perspective on European regionalism based on state-centric realism. Integration comprises economic and political factors (King 1998: 2; El-Agraa 1997: 5; 12-17; 97-111). However, economic aspects of integration gained importance in new regionalism. This paper will concentrate on new regionalism and the political economy of monetary integration.

Monetary, fiscal and trade policies are central tools of states' economic interventions (Mankiw 2000: 312-348). Currency markets connect national economies and affect their sovereignty to pursue favourable economic policies (Cerny 1996: 83-99). However, increased financial globalisation

such as the liberalisation of capital flows and the termination of the Bretton Woods exchange rate system were a political decision (Eatwell & Taylor 2000: 1).

Susan Strange coined the term *financial power* to describe the influence on structures that govern the ability to pursue beneficial monetary policies (Strange 1988: 90-118). The dissertation argues that financial power is a key to stimulating economic growth. Instead of simply eroding financial power globalisation has distributed it unevenly among states and regions. The dissertation examines how monetary regionalism relates to financial power. It will focus on monetary issues and omit fiscal and trade policy from the analysis.

Monetary policy is conducted by central banks. The institutional mandate of central banks and their democratic accountability differ across countries and regions. Central banks have often pursued their own agenda against the will of national governments (Trichet 2007). Further, domestic factors such as the social contract determining wage bargaining relations have an impact on monetary sovereignty (Moore 2006a: 4; see chapter 3.1). However, the central bank's mandate, the social contract and international monetary cooperation itself are political decisions. Within the European Union (EU) despite its high degree of central bank independence the Economic and Financial Affairs Council of the EU (ECOFIN) has the right to determine exchange rate policy (European Union 2006). Hence, it is sensible to assume that policy makers take the financial power of their domestic monetary institutions into account when making political decisions that affect the global distribution of financial power. Therefore, the dissertation will treat central banks' financial power as domestic financial power regardless of the specific institutional arrangement.

¹ Despite globalisation financial markets are concentrated on a few international regions (Corbridge, Martin & Thrift 1994).

Consequently, the dissertation seeks to answer the question of *why EU members sacrificed their national monetary policies in favour of a common currency (euro) against the background of financial globalisation.*

The idea of a monetary union in Europe was spelled out formally for the first time in the *Treaty of Rome* in 1957 (European Union 2002) and was even pursued during the system of Bretton Woods. However, the liberalisation of capital markets and the later crisis of Bretton Woods boosted the development of European monetary regionalism (see chapter 6).

Economic literature explains monetary integration mostly from a regional perspective with reference to price stability and reduced transaction costs (De Grauwe 1997). However, it fails to provide a rationale for Germany's² interest in European monetary integration as the country possessed a well-established niche currency (Bofinger & Flassbeck 2000: 1). Further, it does not provide convincing arguments as to why countries with trade deficits should sacrifice the possibility of competitive devaluation via the exchange rate.

The dissertation argues that regionalism involves different interests within and across nation states participating in a monetary union³. The aim is not a detailed analysis of the objectives of every single nation state for introducing the euro. Instead, the work proposes stylised groups of European states with common characteristics and demonstrates that countries with comparable financial power choose similar approaches to monetary regionalism.

The research is based on a textual analysis (Fairclough 2003) of monetary integration. It utilises a qualitative concept of financial power supported by

² The paper will use the term Germany when speaking of the Federal Republic of Germany, since the German Democratic Republic (GDR) never belonged to the European Community.

quantitative data. A significant attribute to distinguish nation states' interest in monetary integration is their degree of financial power. Accordingly, European monetary regionalism holds two conflicting rationales: a response of the majority of European countries to the globalisation of financial markets and a framework for the (mercantilist) economic agenda of a regional hegemonic country such as Germany. Hence, the competing explanations of regionalism being either a response to or part of globalisation can be reconciled.

The term EMU usually refers to the *Economic and Monetary Union* and includes EU member countries that have preserved their national currency. The dissertation refers exclusively to the decision of countries to abandon national currency. Consequently, the term EMU will be used as a synonym for *European Monetary Union*.

The decisions of important EU members such as the United Kingdom (UK), Sweden or Denmark to abstain from EMU will be considered, albeit not in detail. Countries that tie their monetary policy to the euro, such as Montenegro, Kosovo⁴, the Vatican State or the former West African Franc Zone are not covered. The latecomers to (monetary) integration Malta, Cyprus and Slovakia and specific cases such as Austria (with its former policy of non-alliance), Ireland (with strong economic ties to the UK, which abstained from EMU), Finland (a country rather atypical of the Scandinavian welfare state and a latecomer to integration) and Greece (which had no influence on the preliminary stages of EMU and is widely ignored in relevant literature) will not be examined for comparative reasons. They joined the process of EMU too late to have had a meaningful influence on its design and had very specific reasons to pursue monetary union. Further, textual evidence for their monetary integration policies is hardly accessible.

³ The nation state is the level of analysis of this dissertation.

⁴ The legal status of Kosovo as an independent state or a region belonging to the Serbian Republic is disputed.

The design of the EMU is the result of asymmetric power between the member states and may prove unsustainable. However, an analysis of the architecture of monetary integration goes beyond the scope of this dissertation. Liberalisation and globalisation of financial markets have created volatile economic conditions. But sudden shifts within the financial structure are rare examples in history. The current global economic crisis may, however, become such an occasion. The collapse of the credit system emanates from the leading financial centres of the capitalist economies and might provoke the deepest economic (and political) crisis since World War II. The dissertation can not address the unforeseeable outcomes of the current crisis. Anyhow, the international role of the euro is likely to be affected.

European monetary regionalism reveals some interesting policy options for global regions with little financial power. The current self-help regime in international financial relations puts marginalised economies under recurrent stress. Therefore, monetary regionalism will remain influential as a political concept depending on the success of the European model to cope with global economic crisis and internal conflicts.

Structure of the dissertation

The dissertation is divided into a theoretical section and a case study. The conceptual framework is outlined from the second to the fourth chapter. The case study comprises chapters 5 to 7.

Chapter 2 develops a theoretical perspective on European regionalism. Chapter 3 explains the concept of financial power and its relevance for economic policy. Chapter 4 summarises the preliminary conclusions. Chapter 5 illustrates the rise and demise of the Bretton Woods financial system, and early monetary regionalism in Europe. Chapter 6 reflects the process towards EMU after the crisis of Bretton Woods and highlights

national attitudes towards EMU. Chapter 7 draws final conclusions and answers the research question.

2. The dynamics of European integration

Two central disputes dominate the discourse on regionalism: *whether regionalisation is policy- or rather market-driven* (Haggard & Fishlow 1992: 12) and *whether integration is a response to or part of globalisation* (Hettne 1999: 1-3). The chapter develops a theoretical perspective on these controversies.

Chapter 2.1 introduces a theoretical perspective on regional integration⁵. Chapter 2.2 portrays early European integration while excluding a detailed portrayal of EMU to be discussed in the case study⁶. Chapter 2.3 proposes patterns of national integration policies partially based on the historical section. European monetary integration or late regionalism would have been impossible without early integration. National policies towards monetary integration are better understood on the basis of these patterns. Chapter 2.4 finally discusses the relationship between European integration and economic globalisation.

2.1. Theories of regional integration

New regionalism accelerated in the mid 1980s and after the end of Cold War. The second wave of regionalisation was much broader than older regional movements in the 1950s and 1960s that were largely confined to security issues and trade integration. New regionalism includes the closer integration of economic, political, social and cultural domains with an emphasis on economic harmonisation (Boughey 2003: 46). *New economic regionalism* goes beyond free trade agreements and comprises custom unions in areas such as finance and cross border investment (Gilpin 2001:

⁵ The section draws primarily on Gilpin (2001).

341). The central innovation of new European regionalism was mutual recognition of national standards, increasing competitive pressures on higher regulated economies (Scharpf 1996: 15-40).

The literature has developed a hierarchy of (economic) regionalism: The initial stage is a *Free Trade Area (FTA)* followed by a *customs union* with a common external tariff. The customs union enables a *common market* including the free movement of factors of production (goods, services, people, capital). The *economic union* harmonises monetary and fiscal policies. A *political union* ideally complements economic integration (El-Agraa 1997: 2; Viner 1950).

2.1.1 Economic Theories of Integration

Nation building and integration of territories into larger units are no modern phenomena. Charles Tilly analysed European nation building as a process where the monopolisation of warfare eliminates smaller and inefficient units of power (Tilly 1985: 167-191). However, prior to the post-World War II era economists had written little about the subject of regional integration (Gilpin 2001: 344-345).

European economic integration stimulated the research interest of economists. The most important theoretical contributions are: new institutionalism, new political economy, Jacob Viner's research on custom unions, Marxist approaches, the theory of an optimum currency area (OCA) and new trade and growth theories (Gilpin 2001: 345-348).

New institutionalism explains regionalism with the desire to eliminate market failures and solve coordination problems. *New political economy* focuses on interest groups and redistributive effects of regional integration such as privileging members within the region versus outsiders.

⁶ The section draws primarily upon (Jones 1996) and (El-Agraa 1997).

Consequently, economic integration can be explained as the efforts of domestic interest groups to redistribute national income in their own favour. (Gilpin 2001: 345).

Jacob Viner has sponsored a similar approach. He argued that custom unions with a common external tariff boosted trade within the regional framework and diverted trade outside the region. Viner influenced a lasting controversy among economists about whether regionalism has positive or negative welfare effects on the world economy⁷. For Viner this remained an empirical question, since trade-diverting effects could be compensated by welfare gains inside the region. These gains could possibly benefit the world economy via lower costs of production (Viner 1950; Gilpin 2001: 347)

The *Marxist approach* to regionalism stresses the desire of transnational capital to enhance its competitiveness by increasing its scale of capital accumulation (Mandel 1970).

The theory of an *Optimum Currency Area (OCA)* tried instead to establish criteria that make exchange rates between national economies superfluous. According to that theory external shocks to an economy may be absorbed without exchange rates under the condition that prices and wages or factors of production (capital and labour) are perfectly mobile within a currency area (Mundell 1962).

New trade and new growth theories modified neoclassical assumptions about perfect competition and diminishing returns to scale. Hence, economic integration might imply increasing economies of scale and technological spill-over within the region that improve the bargaining position of their local firms and governments (Gilpin 2001: 348).

⁷ See also (Bhagwati 1997: 865-888)

Jan Tinbergen distinguished policy-driven from market-based regionalism. He labelled the former positive integration and the latter negative integration (Tinbergen 1965). In example, the removal of barriers (e.g. to trade) would be understood as *negative integration* whereas supranational governance implies *positive integration* (Tinbergen 1965).

2.1.2 Political Theories of Integration

Political theories of regionalisation focus on institutional solutions to anarchy and the security dilemma. The most influential theories are federalism, (neo-)functionalism, neo-institutionalism, intergovernmentalism and state-centric realism (Gilpin 2001: 348-349).

Federalism features idealist attempts to overcome the problem of war. It supports federal institutions to take over political autonomy and sovereignty. Federalism emphasises persuasion, winning over public opinion and institution-building. Federalist thought inspired the League of Nations (Gilpin 2001: 349).

Pre-World War II *functionalism* was a response to the failure of the federalist approach, which governed the League of Nations. The leading functionalist thinker, David Mitrany, argued that economic and technological developments enabled and required global integration. Mitrany argued for international cooperation in areas such as health, postal services and telecommunication. He believed that individual states could not deal effectively with complex technical problems, which in turn require international organisations. Mitrany hoped that social and economic welfare gains would enhance further cooperation and finally abolish the nation-state (Gilpin 2001: 349-351; Mitrany 1975).

In the 1950s Ernst Haas developed an influential *neo-functional* theory in the tradition of Mitrany and applied it to European integration (Haas 2004). He adjusted Mitrany's approach, arguing that domestic interest groups exert pressure towards centralised political and technical

management of the economy. Integration spills over into new domains and broadens the scope of regionalism. Finally, these developments produce a regional identity among political elites (Gilpin 2001: 349-352). Neo-functionalism differs from functionalism. It explains regionalism with economic factors instead of deliberate political decisions (Gilpin 2001: 352-353).

Robert Keohane applied *neo-institutional* approaches to international politics. Similar to economic neo-institutionalism, his work dealt with market failures and transaction costs. Political neo-institutionalism focuses on the promotion of political cooperation by mutual recognition of standards (Keohane & Hoffmann 1991; Gilpin 2001: 353).

Domestic politics is a school of thought developed along the lines of economic theory. It supplements theories of regionalism that deal with international aspects of integration. The literature focuses on distributive consequences of integration, domestic institutions and incentives for domestic political elites to pursue regionalisation (Gilpin 2001: 354).

Intergovernmentalism is an influential political theory of regionalism. It focuses on solving problems of economic interdependence between national economies. Andrew Moravcsik argues that European integration primarily reflects three factors: "patterns of commercial advantage, the relative bargaining power of important governments, and the incentive to enhance the credibility of interstate commitments" (Moravcsik 1998: 3). He argues that European integration reflects private economic interests and short-term macroeconomic preferences (Gilpin 2001: 355).

Realist theories of integration emphasise the role of power, national political interests and interstate conflict. They see political integration predominantly as a political decision by nation states in order to achieve domestic political and economic objectives. Robert Gilpin, who champions state-centric realism, argues that successful integration depends on the support of (regional) hegemons (Gilpin 2001: 356).

2.1.3 An eclectic approach to regional integration

The following discussion highlights two main deficits of economic theories of integration: Firstly, political forces of integration such as the security dilemma are not adequately addressed. Secondly, economic theories fail to explain persisting differences in the scope of integration across similar developed regions such as Europe and North America. An economic rationale of integration can not sufficiently explain the different scopes of regionalism.

Economic forces alone, such as comparative advantage of trade, do not create reliable integration dynamics. FTAs without perspective for a custom union or a common market such as the North American Free Trade Agreement (NAFTA) or the European Free Trade Association (EFTA) have been a cul de sac of integration⁸. FTAs exert pressures on less competitive or more protectionist members as different external tariffs for non-FTA members can provide incentives for tariff arbitrage. Hence, FTAs merely reproduce unequal patterns of economic integration (Hettne 1999: 8). Most world regions have failed to attain deeper regional integration beyond FTAs.

Further, regionalism has been a process with many setbacks (e.g. between the first and second wave of regionalisation) and no automatism. Hence, it should be associated with a unique historical environment: The first wave of regionalism reflected the US-dominated framework for post-World War II reconstruction in the countries belonging to the Organisation for Economic Cooperation and Development (OECD) (Hettne 1999: 5). The second wave has been a reaction to the post-Bretton Woods order (liberalisation of financial markets) and the end of the Cold War (Gilpin 2001: 341).

Gilpin argues that new institutionalism, Marxist theories and new trade and growth theories have added insight into the process of regionalisation but they commonly neglected political factors such as security imperatives (Gilpin 2001: 345; 348). Economic approaches have highlighted domestic interest in economic integration. However, they have not sufficiently explained why domestic agents with a preference for regionalism have been successful in lobbying for their interests. Viner's theory did not provide general explanations for economic integration, since benefits differ across regions and their specific modes of integration (e.g. FTAs without external tariffs vs. custom unions) (Gilpin 2001: 348).

In sum, an exclusively economic approach to integration is misleading, since political initiatives have preceded closer economic integration. However, economic theories have explained specific aspects of regionalism

Many *political theories of integration* were inspired by economic approaches and hence fail to provide a comprehensive explanation of integration. They often remain at a rather descriptive level. However, they have been better in their consideration of the political dimensions (i.e. the security problem) that conditioned any deeper integration efforts.

Gilpin argues that federalism has only been successful under very specific circumstances. Federalist states such as the United States of America (US) and Switzerland were a response to external security threats. Federalist economic integration has been mostly the consequence of military conquest of a particular region or a dynastic union (Gilpin 2001: 349).

⁸ The general efficiency of free trade is disputed among economists (Krugman 1987: 131-144; Keen 2001: 50).

Functionalist and neo-functionalist theories focus on spill-over of integration and hence pay little attention to a specific political environment supportive of regionalism. They fail to explain different levels of integration across regions, temporary setbacks such as those between the first and second wave of regionalism and the causes for an initial integration effort. However, on a descriptive level functionalism grasps some features of integration (e.g. overcoming the state-centric prisoner's dilemma by security cooperation).

Neo-institutionalism explains successful cooperation, stressing reciprocity as a driving force of integration. But it also cannot explain the initial impetus for integration (e.g. the role of a hegemon) and has not been developed into a coherent theory (Gilpin 2001: 353).

Domestic politics highlights why some domestic interest groups may prefer regional integration. Anyhow, it does provide little insight into why these interest groups succeed over those that are sceptical of integration (Gilpin 2001: 354).

Inter-governmental theories successfully explain late integration by analysing reactions to economic interdependence and the role of domestic interests. However, they ignore specific political conditions that enabled deeper economic integration (such as security imperatives). Further, they lack a coherent approach to why European integration remains unique across comparable international regions (Gilpin 2001: 355).

The present dissertation adheres to state-centric realism and its perspective on the rival nature of international relations. Specific groups such as organised business frequently share common interests across nation states (i.e. preferring protectionist measures against other world regions) but compete within a region. Even transnational corporations usually develop under a national umbrella and rely on the political resources of nation states (Gilpin 2001: 278-304). Regional political institutions such as the European Commission pursue their own agenda

and "emancipate" themselves if they obtain relevant resources or competencies. Nonetheless, even European governance depends on nation states' consent, since the European Union has neither the budget nor the democratic legitimacy that powerful European nation states enjoy. Hence, a supranational agenda might be the offspring, not the source of regionalism. The present dissertation refrains from extensive elaboration on the domestic forces that determine national interest as the unit of analysis is the state. Consequently, the analysis of states' integration policies should be supplemented by a discussion of domestic politics. However, nation-states continue to exercise the monopoly of power and hence domestic interest groups do operate within the state-centric framework.

2.2. Early European integration

Most efforts to achieve economic and political integration in Europe have been confined to the period after 1945. However, the idea of European unity has a long tradition⁹. It has been influenced by considerations of peace and stability among rival European monarchies and statehoods.

The first institutionalised approach towards European integration after World War II stipulated a perspective for peace and reconstruction across the whole continent. The Economic Commission for Europe (ECE) was set up in 1947 in Geneva as a sub-organisation of the United Nations (UN). However, the Cold War immediately doomed any further prospects of pan-European integration and deepened the divisions along the geographical and political lines of the Cold War.

⁹ The call for a united Christendom originates in the fourteenth century and the proposal for a European Army in the seventeenth century (El-Agraa 1997: 99). In the nineteenth century proposals for a European federation reflected fears of conflicts between consolidated and potent European powers. Finally, after World War I the French Foreign Minister, Aristide Briand, backed by his German counterpart, Gustav Stresemann, proposed a European Union within the framework of the League of Nations or the United States of Europe (El-Agraa 1997: 100).

The United States (US) set the condition that aid (Marshall Plan) to the war-torn European countries was to be administered within a supranational framework. As the Soviets feared Western influence on its satellite states, US aid has been processed through the Committee for European Economic Cooperation (CEEC). The CEEC later led to the Organisation for European Economic Cooperation (OEEC). The ECE had no significant impact on European integration (El-Agraa 1997: 101; 103).

The main pillars of Western European integration were the European Community (EC) and the European Free Trade Association (EFTA) while the Council for Mutual Economic Assistance (COMECON) dominated Eastern European integration efforts (El-Agraa 1997: 101).

COMECON was founded in 1949. The early attempts of countries such as Yugoslavia and Bulgaria to advance regional cooperation (e.g. the Balkan Union) were denounced by the Soviets under Joseph Stalin (Jones 1996: 9). COMECON was largely meaningless until Nikita Khrushchev tried to revive cohesion within the Soviet bloc in the late 1950s. The Soviets insisted that COMECON was not a supranational organisation in order to limit fears of Soviet domination (Jones 1996: 9-10).

The central objective of COMECON was the promotion of interstate trade based on the socialist division of labour. In the absence of a convertible currency most inter-state trade was based on barter agreements. COMECON had no lasting impact on European regionalism (Jones 1996: 9-10).

Western European integration

In 1948 the UK, France and the Benelux countries launched the Brussels Treaty Organisation (BTO), the precedent of the North Atlantic Treaty Organisation (NATO), as a system for mutual assistance against attacks by the USSR. In the same year the OEEC emerged and was followed in 1949 by the Council of Europe (El-Agraa 1997: 102).

The OEEC and the Council of Europe deepened the division of Western Europe into two camps, which are still meaningful today: One camp comprised the UK and, among others, the Scandinavian countries. They later formed EFTA. The other camp incorporated six continental states, namely the Benelux countries, France, West Germany and Italy, which were to establish the EC. The UK had a more sceptical attitude towards closer integration as economic devastation caused by World War II was more severe in Continental Europe (El-Agraa 1997: 102-103). The UK considered itself a major global power whose foreign policy had been tied to the Commonwealth and a special relationship with the United States (El-Agraa 1997: 102).

The division of the two camps became finally institutionalised when the six continental countries created a European Coal and Steel Community (ECSC) in 1951 (based on the French *Schuman Plan*). The Montan Union was designed to revive the German economy while securing peace. The German economy relied heavily on iron, steel and coal, vital raw materials of warfare. A common market for these products would remove impediments on trade, securing equal access to them for all parties irrespective of location and nationality (El-Agraa 1997: 104-105). The ECSC addressed a crucial concern between France and Germany regarding security and sovereignty. The integration of West Germany into the ECSC enabled France to hand back the *Saar region*, a region rich in war-making resources (El-Agraa 1997: 105).

The rearmament of West Germany subsequently became a sensitive issue. The United States of America (US), preoccupied with the war in Korea, pressured European governments to improve capacities for defence against the USSR and raised the issue of a military contribution by Germany. The French government proposed a European Army with German participation. The proposal implied a huge loss of national sovereignty over foreign policy and consequently led to a draft for a European Political Community (EPC) (El-Agraa 1997: 106-107). However,

the French plan for a common defence policy failed to win the approval of the French Assembly. The political forces in France were either opposed to rearming Germany or to exposing the French army to supranational control. A Franco-German defence policy was also tackled by Britain's abstention from the EPC (El-Agraa 1997: 107).

The setback to pan-European integration helped Britain succeed with its proposal for rearming Germany and subsequently integrating it into the NATO. The Eastern European countries reacted to the NATO with the Warsaw Pact (El-Agraa 1997: 108).

A new stimulus for integration emerged in 1955 from an initiative of the Benelux countries for deeper economic integration. The Benelux countries proposed a common market or a European Economic Community (EEC) and an atomic energy pool. Whilst the UK favoured a free trade area under the umbrella of the OEEC, the members of ECSC opted for a fully fledged customs union including the abolishment of non-tariff barriers. However, the concerns differed within the group of six: France viewed a common market critically but welcomed an atomic energy community. The other five members had opposite preferences. (El-Agraa 1997: 108-109). Finally, a consensus emerged that gave birth to the EEC while tolerating non-tariff barriers (Polster 2002: 250)

The Treaty of Rome in 1957 launched the economic community and Euratom. Finally, the "group of six" belonged to three different entities (ECSC, EEC and Euratom) with their own distinct institutions (High Authority of ECSC and Commission of EEC and Euratom). A merger treaty in 1965 enabled the institutions to become branches of a single European superstructure: the European Community (EC) with the Commission as executive and co-legislative organ (El-Agraa: 1997: 110-111). In 1962 the EC had also established a common agricultural policy with the aim of increasing agricultural productivity and devoting more resources to industrialisation. European countries at that time still largely

depended on food imports. Further, different national agricultural policies were considered harmful to a common market (European Union 2007).

In 1969 a summit meeting of national political leaders in The Hague recognised mutual interdependence. The summit declared to strengthen the budgetary position of the EC, embark on an economic and monetary union and to face enlargement. However, the coordination of national foreign policy remained a delicate question (El-Agraa 1997: 112). In 1973 Denmark, Ireland and the UK joined the EC. In 1974 the EC was complemented by the inter-governmental European Council (El-Agraa 1997: 112).

By the 1980s the EC found itself in a deep crisis over institutional progress, foreign and economic policy: Different responses to the Warsaw Pact, the NATO, US presence in Europe and a pan-European defence policy prevailed (El-Agraa 1997: 114). A global recession, mass unemployment and the shift of leading industrial countries towards monetarist policies in the aftermath of the oil crisis defined the economic environment. Southern Mediterranean enlargement (Greece, Portugal & Spain) put internal economic cohesion under stress and required huge transfers of structural funds for those less developed countries. As the European Monetary System complicated macroeconomic responses to unemployment, the EC shifted its focus onto microeconomic adjustments such as liberalising labour markets and increasing international competitiveness (El-Agraa 1997: 114, see chapter 6.1.2).

A new round of regional integration took off in 1987 with the Single Market Act (SEA). The SEA aimed at finalising a true internal market based on the free movement of goods, services, capital and labour by the end of 1992. Its primary means to achieve these goals was mutual recognition of national standards, putting downward pressures on more regulated economies (Scharpf 1996: 15-40). A closer economic relationship with EFTA countries, the European Economic Area (EEA), was negotiated. Further, German unification gave more political and economic weight to

the country. Regime change in Eastern Europe put Eastern enlargement on the agenda (El-Agraa 1997: 115-116).

The European Council met in this unique historical environment in Maastricht in 1991 to produce the decisive *Treaty on European Union*. It entailed a timetable for a full Economic and Monetary Union, brought institutional changes and enlarged the scope of European decision-making (e.g. extending qualified majority voting in the European Council to more political areas). Finally, it brought the current structure of the EU, which rests on three pillars: Firstly, the fully supranational European Communities (ECSC, EEC and Euratom) or the common market, secondly, the common foreign and security policy and thirdly, cooperation in the field of justice and home affairs. The second and the third pillar remain largely embedded in inter-governmental decision-making. (El-Agraa 1997: 116-117).

EMU led to the introduction of the Euro as accounting currency in 1999 and its final inception as physical money in 2002 (European Union 2008). The Treaties of Amsterdam (1997) and Nice (2001) complemented the Treaty of Maastricht (1992). However, efforts to ratify a Treaty establishing a European constitution (TEC) were rejected in popular votes in France and the Netherlands in 2005. The Treaty of Lisbon (2007), which re-tabled the core of the TEC institutional reforms, subsequently failed to win approval from the Irish electorate (European Union 2008).

The *aquis communautaire* requires new EU member states to adopt primary and secondary European law accumulated in the integration process. It has become a powerful tool to ensure free market policies across the EU by legal force (often against the concerns of national stakeholders such as trade unions). The current EU comprises 27 member countries. Croatia and Turkey have formally applied for membership, and Stabilisation and Association Agreements are being negotiated with many of the new states that belonged to the former Republic of Yugoslavia (European Navigator 2007).

Dynamics of European regionalism

In sum, the motives for early Western European integration were fears of another exhausting war, the perception of Soviet aggression and the risks of an economic collapse (Jones 1996: 4).

Robert Brenner argues that the United States administration consciously accepted an international economic framework where capital controls, fixed exchange rates and trade liberalisation gradually hurt US trade interests. The US wanted to secure political influence over Western Europe against the USSR and provide US corporations with profitable investment opportunities abroad (Brenner 2002: 15).

Hence, European integration benefited from a unique integration environment or hegemonic support (within the region and in the global political order). According to Gilpin, the US hegemony in the Western hemisphere has enabled European integration while it potentially undermines its own global leadership (Gilpin 2001: 10-12). The US approach towards European integration might therefore become more hostile in the future (Dinan 1994: 62).

However, early European integration has demonstrated the role of national interests in determining the character of the regional framework. The subsequent chapter will propose patterns of national integration policy that correspond to the history of early European integration and are critical for understanding EMU.

2.3 National patterns of European integration

The *UK* and the *Nordic countries* (except Finland for security related reasons bordering the former USSR) are sceptical of supranational integration. Historically, they have rarely been involved in Franco-German-Russian conflicts and were less affected by the devastation of World War II than Continental Europe. Hence, their willingness to sacrifice national sovereignty has been less pronounced. They subsequently embarked on the respective Anglo-Saxon and Scandinavian economic models, two opposite poles which both differ from Continental European *Rhenish Capitalism* (Esping-Anderson 1990). They have both developed a rather unilateral response to economic and political challenges. The UK's attitude towards European integration has been influenced by its former role of World Power and its special relationship with the US.

Continental European integration has been largely driven by *France's* security concerns and its desire to avoid confrontation with the rival hegemon Germany. Post-War France has been sceptical of *market based* economic integration such as the EEC (which impaired its own post-World War II concept of *Planification*; the country is also driven by concerns over Germany's competitive advantage). However, France opted for multilateral security cooperation independent of the NATO¹⁰. France's stance on security cooperation reflected its loss of political status in comparison with the Anglo-Saxon countries. Hence, the country aspired to utilise European resources for its national agenda. Certainly, the parliamentary refusal to accept an EPC and a common defence policy demonstrated the limits of French regionalism. France usually prefers intergovernmental bargaining over federalism (see chapter 6).

¹⁰ Recently, France has announced its intention to normalise its relationship with the NATO (Valasek 2008). It remains yet unclear whether this serves to distract US concerns over a possible emancipation of European security policy or indicates a shift in the French attitude towards transatlantic cooperation.

Germany hoped to regain sovereignty in international relations after World War II. The terms of the Saar region agreement with France required the German participation in the French initiative for an ECSC. Political sovereignty was a prerequisite for Germany's subsequent economic recovery as the Saar region was rich in vital raw materials. The international support for a rearmed Germany demanded integration of the country into some type of multilateral defence architecture. The integration of West Germany into the NATO has prevailed over a common European defence policy. However, the rearmament of Germany depended on the agreement of its former European war adversaries, especially its neighbouring country France. Hence, Germany's close cooperation with France in early European affairs has been instrumental for its own consolidation of economic power. Germany's quick economic recovery, the sound basis of its war-related industries and its well functioning social contract (price stability and centralised wage bargaining) (European Commission 2009: 76; see also chapter 3.1.) have assisted its competitive free market approach to regional integration.

The *Benelux Countries* pursue a federalist approach to integration. The initiative for the EEC and Euratom is indicative of the Benelux countries' preferences: They possess only limited relative power in foreign policy and are geographically located between two regional hegemonies (see chapter 6.1.1 and 6.3). The small internal markets and their geographical setting at the heart of Europe contributed to a high preference for openness to trade and thus competitiveness. Hence, the Benelux countries favoured supranational institutions with democratic checks and balances to the bargaining power of the regional hegemonies. However, their economic concepts of integration differed with respect to their economic and political weight. Belgium and Luxembourg often sided with France in monetary affairs, whereas the Netherlands supported the German approach to monetary integration (see chapter 6.1.1 and 6.3).

The *Southern Mediterranean* countries are sceptical of free market policies due to a lack of economic competitiveness and high dependence

on structural funds. However, similar to the Benelux countries, they possess marginal political weight in the international arena since their respective military and colonial dictatorships have collapsed. Further, they have a rather weak social contract (European Commission 2009: 76). Therefore, they favoured positive integration in political and economic affairs. Italy played an exceptional role. It temporarily sided with Germany in its approach to economic integration due to its historical ties with the country and bargains over structural funds (see chapter 6.1.1 and 6.3).

In sum, the history of early European integration has illustrated the vital role of national (security) concerns for the dynamics of regionalisation. The specific integration environment after World War II was characterised by the support of a global hegemon for integration (for political and security concerns), the war-related devastation and the inability of the regional hegemons to consolidate power against each other¹¹. Monetary integration without security cooperation seems an unlikely event. However, the experience of collective vulnerability can facilitate integration (e.g. monetary regionalism has become more prominent after the financial crisis of the late 1990s, see chapter 3.2.4)

In the next chapter the relationship between regionalism and economic globalisation will be discussed.

¹¹ Heribert Dieter argues that monetary regionalism in Asia will not prevail until either China or Japan has established itself as regional hegemon. Japan demonstrated considerable reluctance towards responsible regional monetary and economic leadership during the Asian financial crisis of 1998 (Dieter 2008: 25-30; 32).

2.4. Regionalism and economic globalisation

Two questions dominate the discourse on regionalisation: *Whether European integration is a response to or part of globalisation and whether it is policy- or market driven.* The answer to these questions may help to properly understand the logic of monetary regionalism.

A market-driven logic of integration as argued by Walter Mattli (Mattli 1999) indicates that regionalism is rather a booster of globalisation, whereas a policy-driven approach would be associated with regionalism being a shield to globalisation. However, some authors in the liberal tradition believe that FTAs undermine global economic integration (Bhagwati 1997).

The liberal or idealist tradition in International Relations understands economics as a positive-sum game making integration favourable (Art & Jervis 1992: 232-233). A realist or mercantilist perspective is based on the rival nature (zero-sum game) of economic relations (Art & Jervis 1992: 233).

From a realist perspective market-driven integration as well as policy-driven integration could both indicate a mercantilist response to economic competition. The customs union is a good example of the dialectic nature of regional integration. It enabled trade liberalisation within the EU while imposing a common external tariff. Hence, the relationship of regionalism with globalisation does not depend so much on the driving forces of integration but on the specific design of the regional project (i.e. positive or negative integration).

Robert Gilpin sees regionalism predominantly as a response to globalisation. However, Gilpin acknowledges that regionalism differs over space and time. For Gilpin Western European integration is much more policy-driven while Pacific Asian regionalism is rather market-driven (Gilpin 2001: 341-343). Hettne suggests that the phenomena of globalisation and

regionalisation mutually support and contradict each other (Hettne 1999: 3).

The present dissertation adheres to an eclectic approach. The design and purpose of regionalism depends on the relative power that certain nation states and/or domestic interest groups enjoy. The dissertation identifies national policies towards monetary regionalism and their impact on European regionalism rather than defining the character of regionalism on a purely theoretical basis.

The dissertation argues that the deadlock of rival powers within Continental Europe and the policy of the United States towards its Soviet counterpart have promoted Western European regionalisation. While the initial impetus has been primarily policy-driven, the later development of the European project was rather market driven (Karrass 2006). One of the reasons for that shift has been the consolidation of German power and its mercantilist economic agenda.

Chapter 3 will specify the concept of financial power in order to qualify the research hypothesis that financial power determines nation states' monetary integration policies.

3. The concept of financial power

Power is a crucial aspect of everyday living; yet the role of power has been widely ignored in economic theory (e.g. in determining market outcomes) (Rothschild 1971: 7). Joseph Nye postulated: "Power, like love, is easier to experience than to define or measure". (Nye 1990: 177). However, commercial power and military power are central to the studies in international relations (Art & Jervis 1992; Balaam & Veseth 2000: 25-42).

Some authors argue that the character of power has fundamentally changed. According to Nye, soft power or the ability to influence the

behaviour or interests of other political bodies by cultural or ideological means has become increasingly relevant in international politics. Soft power mainly serves to circumvent the huge costs associated with hard power (Nye 2004). Mark Leonard argues that the EU exercises a significant degree of soft power by shaping the legal frameworks of countries whose governments wish to join the common market (Leonard 2006: 67-69).

The dissertation assumes that soft power is neither new nor has it substituted hard power. For example, the colonial mission civilisatrice combined soft power (religion) with hard power (force) (Paris 2002: 627-656). James Scott argued that under conditions of (economic) dependency people advance their interests (e.g. demanding charity from wealthier members of a religious community) within the limits of dominant cultural and religious ideologies for pragmatic reasons (Scott 1985). Hence, soft power is often a by-product of tangible economic incentives such as the advantages of operating within a common market (Leonard 2006: 76). Nonetheless, the work of Antonio Gramsci or the concepts of *political culture* have provided strong arguments against mono-causal perspectives on power (Adamson 1983; Berman 2001: 231-250). Therefore, it is important to identify whether the specific domain being analysed may be properly isolated from other factors determining political behaviour (e.g. ideology or culture). The dissertation assumes that monetary policy and financial power are too relevant for economic interest groups to be predominantly explained with ideology. For example, ideology alone cannot be the reason why the US with its strong free market approach applies pragmatic monetary policies if mainly inspired by an economic paradigm.

Political behaviour does not necessarily reflect rational interests (Johnson 1997: 170-174). However, some constant national patterns¹² of regional integration have been observed over large time spans and across governments with different ideological roots. Hence, the present dissertation works on the premise that national patterns of economic and security imperatives determine international relations.

Susan Strange observed a shift from *relational power* to *structural power* in the competitive game of the World System. Strange defined relational power as “the power of one player to get another player to do something” (Balaam & Veseth 2000: 17), whereas “structural power (...) (meant) the power to shape and determine the structures of the global political economy (...)” (Strange 1988: 25). She argued that four sources of structural power dominate the international political economy: *security*, *knowledge*, *production* and *finance* (Strange 1988: 29-32).

Strange understood financial power as the *ability to create credit (lend) and to “manage or mismanage the currency in which credit is denominated, thus affecting rates of exchange with credit denominated in other currencies”* (Strange 1988: 90).

She argued that the financial structure consists of two inseparable aspects: *The structures of the political economy through which credit is created and the monetary systems which determine the relative values of the different moneys*. Strange saw the power to create credit shared by governments and banks while the power within monetary or exchange rate systems depended on the relationship between states and markets (Strange 1988: 90).

¹² National patterns do not necessarily reflect a collective experience such as hyperinflation in Germany in the 1920s as commonly suggested. Similar events across different countries did not produce the same responses. These patterns rather reflect one possible response among many to a change in the (international) economic structure that subsequently becomes institutionalised (Hegemann 2007: 50). These relatively constant approaches of the political elites imply the perception of a rational national interest or at least the interest of dominant political agents.

Strange considered the US credit supply after World War II to be far more relevant to Western economic development than trade liberalisation and the Bretton Woods exchange rate system (Strange 1988: 103-104). The amount of capital committed to Europe during the Marshall Plan was substantially larger than the assistance by the International Monetary Fund (IMF) under the Bretton Woods agreement (Eichengreen 1996: 98). Further, intra-European trade linkages after WW II were initially low (Polster 2002 109-110).

However, the domestic capacities to create credit became gradually more relevant and were surely conditioned by the exchange rate system (see chapter 3.2). The Marshall Plan and the actual design of the Bretton Woods financial system both expressed the United States' desire to secure political and economic influence over Europe versus the Soviet Union (Strange 1988: 103). The role and the mandate of the IMF became more substantial when the US realised that the European Payment Union (EPU) bore the seeds of a pan-European alternative to the international monetary system (Polster 2002: 131).

Further, the Bretton Woods financial system was more than an exchange rate mechanism. It entailed a specific approach to capital flows (capital restrictions) relevant for the management of currencies. Hence, it should be assumed that both aspects of Strange's illustration of the financial order (domestic institutional arrangement and international monetary system)¹³ had a significant impact on domestic economic policies.

¹³ Werner Polster distinguishes between monetary orders and monetary systems. A monetary order may be regulated or market-driven, while a monetary system entails a contractual arrangement such as the Bretton Woods agreement (Polster 2002: 75-86). However, this dissertation will utilise the original terms as far as it refers to other people's work such as Susan Strange's definitions.

Financial Power

In sum, financial power is the *potential* to pursue favourable monetary policies (low real interest rates) without external disturbance (erratic exchange rates). Financial power is a qualitative concept. The dissertation argues that different degrees of financial power explain the choice of national policies with respect to monetary integration. It proposes indicators to measure financial power and examine that claim. The main indicators utilised are the status of the currency as international reserve currency, a positive trade balance with other EU countries, moderate inflation and an insulated internal market (little openness to trade).

The *status as international reserve currency* reflects and supports investors' willingness to utilise the currency as a store of value and means of transaction, thus stabilising its external value and relaxing external constraints on monetary policy. A positive *trade balance* can be associated with more financial power, since monetary policy is not bound by high relative inflation compared to trading partners, and the country is a net creditor towards other nations. *Lower inflation* broadens the scope for expansionary monetary policy and is therefore associated with more financial power. A *high openness to trade* translates into less financial power. Open economies are more vulnerable to exchange rate movements and more dependent on price stability to maintain a favourable trade balance. The strength of the social contract (see chapter 3.1 and chapter 6.3) is a relevant indicator of financial power and could be generally measured by the degree of collective bargaining centralisation (European Commission 2009: 76). However, in some EMU countries such as Germany wage erosion has been observed despite a strong corporatist tradition and high wage bargaining centralisation. Restrictive fiscal policies, labour market and social security reforms have considerably weakened the bargaining position of trade unions (Schettkat 2006: 209 - 215). As a result, defining the strength of the social contract has become more complex and less straight-forward in recent years. Therefore it will be

ignored as a quantitative indicator in the empirical section (see *chapter 6.3*).

The indicators are difficult to separate. For example, low inflation may be the consequence of high interest rates. Countries with great financial power may forgo their monetary potential for the sake of an economic agenda (e.g. "competitiveness"). Hence, actual monetary or interest rate policy is no adequate indicator of financial power. Conversely, higher inflation may signal financial leadership (e.g. the US absorbing goods and services from the rest of the world). However, this is not the case within the EMU. Further, an indicator such as the trade balance does not only reflect financial power but the overall structure of the economy. Thus, the dissertation will mainly rely on theoretical or textual analysis. The indicators merely serve to test the consistency of the proposed patterns of monetary integration policies.

The dissertation shares Strange's perspective that states with large financial power can pursue desired macroeconomic policies across different monetary regimes. Conversely, national monetary institutions with little financial power experience larger monetary restraints under certain regimes. Today, capital flows nearly equal the currency reserves administered by central banks (Polster 2002: 244-245). Consequently, the domestic power to create credit is not only shared between governments and banks (the domestic institutional framework) but also between states and markets (the monetary or exchange rate system). Therefore, the dissertation will primarily focus on the second aspect of Susan Strange's definition of the global financial order: the international monetary or exchange rate system including the regulation of capital flows (Strange 1988: 90).

Significant changes in the structures of the international political economy such as the termination of the fixed exchange rate system or the EMU are very rare occasions in history. The dissertation is concerned with the process towards EMU. Therefore, it will focus on power within the post-

Bretton Woods order rather than on the power to redesign the whole financial structure. However, the recent global economic crisis may imply huge changes in the financial order (e.g. with regard to the lead currency status of the US dollar).

Financial power in a regime with no global or multilateral currency depends heavily on the status of a national currency as international reserve medium. Presently, the US dollar is the international central banks' preferred foreign exchange medium and dominates international trade in important commodities such as oil ('The disappearing dollar' 2004: 9). Recently, speculations have emerged over the euro substituting the dollar as leading reserve currency¹⁴.

The dissertation argues that, although Europe might aspire to financial leadership as a consequence of monetary integration, the initial stimulus for monetary regionalism is best explained with national agendas. National commercial patterns (e.g. the German mercantilist agenda) are a serious obstacle to Europe's provision of international liquidity¹⁵. However, financial leadership requires a central bank's willingness to act as international lender of last resort (Gilpin 2001: 256). The ECB with its tight monetary approach has so far been reluctant to accept that responsibility (Issing 2007: 31). Global financial leadership also correlates with political leadership (Magdoff & Sweezy 1987: 163-175). However, the EU has so far made little progress in establishing itself as a coherent political entity in areas such as defence and security.

¹⁴ The euro is the second lead currency. Roughly 26 per cent of global currency reserves are held in euros. The national currencies within the euro area had occupied only 18 per cent of foreign reserves prior to the currency union. The role of the euro in international trade and in foreign exchange transactions is constantly expanding (Deutscher Bundestag 2008).

¹⁵ Interestingly, the same reluctance towards financial leadership can be observed with respect to Japan's role in Asian monetary regionalism (Dieter 2008: 25). Germany and Japan are comparable countries since both have adopted policies that kept growth and inflation low, while supporting a huge trade surplus (Kitazume 2005).

In order to qualify the argument that credit (the first aspect of Susan Strange's definition of financial power) enhances growth, the next chapter will provide a brief overview over the role of money in economic theory.

3.1. Financial power: The role of credit

Economic theory has identified investment as the primary source of technological progress and thus of growth. The major division in economic theory is the role of money for investment¹⁶:

The *classical or political economists* observed the emergence of European capitalism and conceptualised a barter economy. The available pool of capital for investment restricts the growth of a barter economy. The role of money is limited to being a store of value and facilitating the exchange of goods and services¹⁷. As the level of productivity in agriculture is low, the population consumes most of the output and few resources are left for investment. Workers' salaries have to be kept at the subsistence level in order to reserve any surplus for additional investment (capital restriction) (Lowe 1975: 415-425). Therefore, the appropriation of surplus labour from workers is a precondition to finance investment (Reismann 1985: 4). In other words, saving is non-volitional and determines investment.

¹⁶ The term investment refers to both productivity- and capacity-enhancing investment. More recent versions of (neoclassical) economic growth theory have introduced concepts such as "human capital" to explain (exogenous) technological progress (Wurm 2006). However, in that instance investment (e.g. investment in education) continues to explain growth.

¹⁷ A notable exception among classical economists is Karl Marx, who acknowledged the role of money advances when referring to the realisation problem and the circuit of capital. Money allowed investment and additional production to exceed consumption, assuming that capitalists undertake investment in order to generate profit or accumulate wealth. Unfortunately, the discourse on Marxian economics has mainly centred on the labour theory of value and the tendency towards a diminishing rate of profit that involves conceptual problems (Hein 2006: 113-140).

In *neoclassical economics* the available pool of capital likewise restricts growth. However, as workers' or private households' incomes are not necessarily kept at the subsistence level, they may save income. Therefore, the available pool of capital depends upon the "volitional decisions of economic units to save their money and abstain from consuming" (Moore 2006a: 2). If more (less) investment is desired than savings available, interest rates will rise (fall) and induce more (less) savings and less (more) investment. The money market transfers savings to investors, and interest rates are endogenously determined by supply and demand of money (Fisher 1930). Hence, in neoclassical economics money remains a store of value and a means of transaction with no implication for growth. The growth rate is exogenously given by the combination of factors of production and exogenous technological progress (Solow 1956: 65-94).

In the *monetarist version of neoclassical economics* any additional supply of money (credit) beyond the growth rate of the economy will simply cause prices to rise (inflation). The demand for money is a function of income. Free movements of capital and freely floating exchange rates will compensate inflation and interest rate differentials (Krugman & Obstfeldt 2003: 341-350). Thus, the domestic monetary institutions are the culprits of inflation. Consequently, the growth of money supply should be firmly controlled by central banks according to a fixed rule (Friedman 1969).

(Post-)Keynesian and *Schumpeterian economics* differentiates between the (historical) development of barter economies, where growth is restricted by capital, and modern monetary economies. A modern monetary economy is primarily restricted by the effective demand for goods and services, and insecure expectations¹⁸ (Moore 1988; Messori 2002). Hence, in monetary economies investment does not depend on savings

¹⁸ The concept of insecure expectations must be separated from the neoclassical concept of probability and risk. The latter allows the prediction of certain market outcomes with statistical tools (Knight 1921: 233).

but, instead, savings are the accounting record of investment (Moore 2006a: 2-3). To illustrate the argument: In a stationary economy, where all the available output is consumed, additional savings can only occur if investment raises income. Money or credit finances these investments (Bertocco 2007: 101-122).

In modern credit economies half of the finance for investment spending is provided by corporate retained earnings while the other half is primarily raised by bank borrowing (Moore 2006a: 2). Loans or bank borrowing results in newly created deposits (money). In practice the central bank supplies any reserves demanded by banks to support this level of deposits at a given interest rate. The (short-term) interest rate is exogenously determined by the central bank (Moore 2006b: 208-214). As a consequence in Keynesian theory, savings or the available pool of capital are not a restraint on investment (growth) and "most saving is no longer volitional" (Moore 2006a: 2).

Money is not neutral and constitutes a decisive source of investment and, hence, income which in turn impacts on consumer spending. Further, central banks have no direct influence over the money supply as economic agents' demand for money is determined endogenously (with respect to their expectations of future income). Hence, additional creation of money must not result in inflation if an economy is operating below its capacity level. Certainly, "too much money chasing too few goods" might cause inflation if the economy has reached its temporary capacity level. However, additional money could also create additional productive capacity. Therefore, in economies operating below their capacity level inflation is explained with the development of unit labour costs. *External factors* for inflation are changes in the relative values of money (exchange rates) and the prices of important input factors (i.e. oil). (Moore 1988).

Lately, a *new consensus* (neoclassical-Keynesian synthesis) has emerged. It stipulates that money is relevant in the short run (as prices are sticky). However, in the long run the neoclassical proposition on money

prevails as an expansionist central bank loses credibility with rational economic agents and the production capacity is fixed. Wages and prices will adjust and neutralise the expansionary effects of monetary policy (*money illusion*). Thus, monetary policy is at best an option to restore full employment within the given production capacity (Moore 2006b: 247-252).

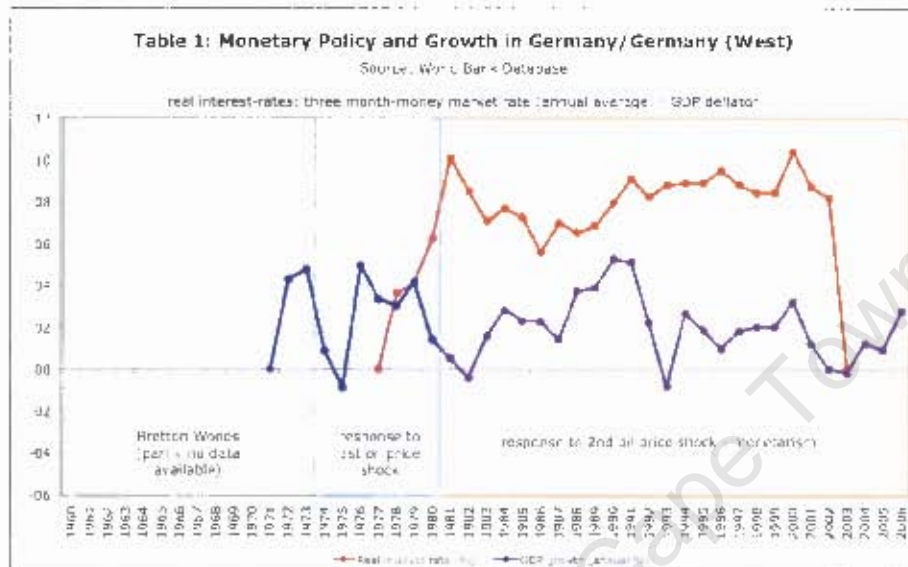
3.1.1 The role of credit in the real world

The dispute about the role of money for economic development is a chicken-egg problem. Empirical studies validate both assumptions: a correlation between Inflation and unit labour costs (economic indicator) as well as increasing money supply during periods of accelerating inflation (monetary indicator) (Moore 1988). However, central banks' attempts to directly influence the money supply have proved unsuccessful. The huge swings and upward trend in the prime lending rate set by institutions such as the US Federal Reserve Bank (FED) during its monetarist period indicate an endogenous money demand and have led to a public reversal of money supply targeting among most central banks (Moore 2006b: 233-234). Therefore, increasing money supply seems rather the by-product of inflation than vice versa¹⁹.

The *Deutsche Bundesbank* was one of the few central banks that (officially) adhered to pure monetary targeting. It had a great influence on the monetary strategy of the ECB, which, however, is based on two pillars: the analyses of economic and monetary indicators (European Central Bank 2008). The two pillars were primarily a political compromise and a signal to the financial markets that the euro would become a safe store of value for financial investors (see *chapter 6*). In practice, the Bundesbank

¹⁹ Price hikes of crude materials and energy accelerated inflation prior to the recent economic crisis. However, they can be clearly attributed to speculative patterns. Neither patterns of supply and demand nor lending activity by central banks explain these price movements since core inflation remained low (Schulmeister 2008). A tighter monetary policy would have been likely to induce more financial speculation due to higher interest rates and would have made the crisis more severe.

also followed a rather pragmatic stance when such was deemed necessary (e.g. to keep the exchange rate within a certain parity to other currencies) (Issing 1997: 67-79). The pragmatic monetary strategy of the FED was much more successful in terms of growth (and employment) than the monetarist policies of the Bundesbank (see *Tables 1 & 2*).



3.1.2 The monetary policy tools of central banks

Central banks regulate monetary policy with Open Market Operations (OMOs) through purchase and sale of government bonds. If a central bank sells government bonds to the public, it receives money and hence takes liquidity out of the market (Gilpin 2001: 371).

A different tool is the discount or repo rate that regulates the rate at which financial institutions can borrow money from the central bank. Further, central banks can adjust reserve requirements for commercial banks (Gilpin 2001: 372). The reserve requirement is critical to central banks' monopoly of money emission. It ensures collateral influence on money substitutes such as credit cards issued by commercial banks.

These three monetary tools are the main transmission channels by which central banks can influence the *short-term interest rate*²⁰ relatively precisely. The central bank sets an upper or lower ceiling for short-term interest rates in a competitive banking sector.

The *long-term interest rates* relate to fixed-interest bearing assets and shares and are not as closely controlled by central banks²¹. However, they usually lie above the short-term rates. Long-term assets are less liquid than short-term substitutes. If economic agents face fundamental insecurity about the future and favour flexibility or liquid assets, they will usually demand a higher premium for long-term assets. Further, expectations about monetary policy and asset valuations influence long-term rates. In most instances there is an inverse relationship between interest rates and asset values. If short-term interest rates rise, fixed-interest-bearing assets and shares become less attractive as an investment or store of value (Keynes 1936). However, if investors

²⁰ Defined as the three month money market (Federal Reserve Bank of New York 2008)

²¹ Alan Blinder has put it this way: "(...) the interest rate that the central bank can control doesn't matter (much), and the rates that matter cannot be controlled". (Blinder 1998: 30).

anticipate economic decline, long-term rates can sink below short-term rates since financing in the present appears more risky.

The dissertation utilises real short-term interest rates as an indicator of monetary policy (see *Tables 1 & 2*) as they can be controlled by central banks and usually do set a lower ceiling for the long-term rates. Real interest rates take inflation or growth into account. Nominal interest rates do not allow for any comparison of monetary policy, because identical interest rates can be relatively low or high under different economic conditions.

3.1.3 A theoretical concept of money

The present dissertation adheres to a (post-)Keynesian perspective on monetary policy. That perspective is fully in line with Susan Strange's argument that financial power or the ability to lend has a pronounced impact on economic development (Strange 1988: 90).

The distinction between the short and the long run as suggested by neoclassical economics is irrelevant, since economic agents face fundamental insecurity about the future²² (Moore 2006b: 112-119). Even in neoclassical economics the capital stock affects growth potential (Solow 1956: 65-94). Hence, the assertion that money has an influence on the capital stock in the short run but no impact in the long run is not convincing.

In Post-Keynesian economics the domestic wage bargaining system or *social contract* is of crucial importance to financial power as unit labour costs mostly explain inflation. Economies with centralised wage bargaining systems (corporatist model) usually experienced moderate inflation since wages followed average growth in productivity (Cukierman & Lippi 1999:

1395-1434). Monetary policies can be less restrictive if effectively coordinated with wage policy. Anyhow, not all central banks are willing to loosen or coordinate monetary policy in response to corporatist trade unions (e.g. Deutsche Bundesbank).

However, EMU member states have concentrated on adjusting monetary policies and increasing financial power rather than adjusting the domestic social contract to deflate their economies. Restrictive monetary policies or unemployment are more readily available tools for keeping inflation at bay. The adjustment of the domestic social contract is a far more complicated and time-consuming process for governments. It may provoke political opposition from domestic interest groups. Independent central banks are democratically less accountable and hence less permissive towards political opposition²³. Further, the external sources of inflation (exchange rates, prices of imported goods) are often of greater relevance to small vulnerable economies with a pronounced openness to trade than domestic sources. To the contrary, most European countries have sufficiently weakened their social contracts to withstand competitive pressures from a monetary union without economic governance (Herr & Kasandziska 2007: 131-162).

The next chapter will illustrate that the *ability* to pursue favourable monetary policy (lowering interest rates, thus making a greater variety of alternative investments profitable) without inflationary pressures is heavily conditioned by the international monetary system and its distribution of financial power.

²² Keynes famously observed in the *Treatise on Money* (1936) "In the long run we are all dead!"

²³ The influential civil servant of the British Treasury Sir Alan Budd argued that many in the Thatcher government "never believed for a moment that [monetarism] was the correct way to bring down inflation. They did however see that this would be a very good way to raise unemployment. And raising unemployment was an extremely desirable way of reducing the strength of the working classes." (Cohen 2003: 21)

3.2. Financial power: The role of the international monetary system

The adequate design of the exchange rate regime has split generations of economists. Free market economists usually favoured flexible exchange rates, whereas Keynesian economists argued for fixed but adjustable or no exchange rates. However, the division has even cut across economic paradigms (Sardoni & Wray 2007: 53-77).

Lately, the economic mainstream tends to emphasize the *corner solutions* of the exchange rate regime; irrevocably fixed or freely floating exchange rates (Summers 2000: 1-17). The core of the debate is the so-called *unholy trinity*, which states that economic policy can never reconcile more than two goals at the same time: monetary policy independence, openness to capital flows and stable or fixed exchange rates (Gilpin 2001: 248).

The chapter will illustrate the controversy and develop a theoretical perspective on how the monetary or exchange rate regime affects financial power. Based on that analysis, the dominant fashion of corner solutions and the claim of an unholy trinity will be reviewed critically.

3.2.1 The case for flexible exchange rates

The case for flexible exchange rates is fundamental to the controversy on monetary sovereignty and will be illustrated in detail.

Flexible exchange rates are usually seen as a necessary buffer against real shocks to the economy or wage and price rigidity (De Grauwe 1997: 5-11). Further, only flexible exchange rates would allow monetary policy autonomy while fixed exchange rates support fiscal policy (Mundell 1962; Fleming 1962).

The argument for exchange rates being a buffer against real shocks (positive and negative supply/demand shocks) is central to the theory of

Optimum Currency Areas (OCAs). OCA theories tried to establish criteria that may answer the question of whether exchange rates between regions or countries are necessary or superfluous. An exogenous shock may occur due to a sudden shift in economic policy or even natural disasters such as an earthquake. The latter example shall illustrate the case:

An earthquake that destroys most of the productive capacity of a region or industry would be labelled a negative supply shock (negatively affecting the supply side of the economy). Since a reduction in productive capacity *ceteris paribus* causes inflation (demand for goods and services remains the same), the industry or region loses competitiveness (inflation) and jobs (less output). Monetary policy is complicated in such a situation, because a lowering of interest rates might accelerate inflation while a tightening of monetary policy will make new investment dear. Consequently, there remain four options to counteract the negative effects of a negative supply shock: Firstly, the domestic currency might be devalued to restore competitiveness. Secondly, producer might lower prices and sacrifice profits to stabilise market shares. Thirdly, workers could abstain from wage increases as a response to inflation. Fourthly, workers could migrate into the competitive region that wins market shares or conversely capital could flow into the affected region realising higher returns on investment.

Consequently, OCA theories assume that in the absence of flexible wages and prices or factor mobility (labour and capital) exchange rate adjustments are required (and vice versa) (Mundell 1962). Hence, OCA theory is open to both outcomes: the need for exchange rate adjustments with sticky prices and immobile factors of production, and the abolition of exchange rates (monetary union) if prices or factors of production are sufficiently flexible.

The purchasing power parity (PPP) and the (uncovered) interest parity (UIP) are the very basis of the case for flexible exchange rates. They can be summarised in the relationship

$$e^* = i^* = p^* \text{ (Flassbeck 2001: 13)}$$

The relationship suggests that in the long run with exchange rate expectations being rational exchange rate expectations (e^*) will always equal the interest rate differential (i^*) and price level differential (p^*) across economies. For example, if the price level or the interest rate in a domestic economy rises more than in a foreign economy (the former amounts to an appreciation of the real exchange rate, since domestic goods buy more foreign goods), the *expected* nominal exchange rate will also rise from the perspective of the domestic economy (its currency will depreciate). The real exchange rate thus remains stable in the long run (see *Appendix I*).

In consequence, exchange rates will always equalise the purchasing power across economies, eliminating sustained trade imbalances. Further, expected returns on currencies reflect the nominal interest rate differential and expected changes in the nominal exchange rate. Hence, according to UIP, financial arbitrage will restore equilibrium on the asset markets (Krugman & Obstfeld 2003: 394-396, see *Appendix II*).

These assumptions have a pronounced impact on the *effectiveness of monetary policy*:

If the neoclassical proposition on money and UIP holds, a (temporary or permanent)²⁴ monetary stimulus can at best restore full-employment within given capacities. In the long run the currency will appreciate after the money supply has been increased and prices will rise (neutralising any further effects on output). Permanent fiscal policy is assumed to be ineffective under flexible exchange rates since it “crowds out” private investment and the exchange rate will negatively affect the trade balance²⁵ (Krugman & Obstfeld 2003: 450-460).

²⁴ A policy is usually defined as permanent over the time span of one year.

²⁵ Post-Keynesian proponents of flexible exchange rates do not share that perspective. They argue that a central bank can exogenously influence the interest rate and hence

Conversely, the adverse impact of fiscal policy on the exchange rate may be neutralised under a *fixed exchange rate regime*. But *monetary policy* is difficult in the presence of free movement of capital. Financial investors will not be willing to hold currency assets with a lower return (interest rate) without an expected currency appreciation. Economic policy has to restrict the movement of capital (Mundell 1962; Fleming 1962).

In sum, monetary policy can only (temporarily) affect the output of an economy under flexible exchange rates or if the free movement of capital is restricted. This constitutes the core of the unholy trinity.

3.2.2. The case for fixed but adjustable exchange rates

A system of fixed but adjustable exchange rates requires a multilateral approach to the determination of currencies, whereas a monetary regime of flexible exchange rates has a unilateral character (*self-help regime*). As shown previously, proponents of flexible exchange rates argue that there is no need for a multilateral coordination of exchange rates, since financial markets create equal conditions for any currency. No government can exploit monetary policy or the exchange rate, since PPP and UIP will always prevail. Further, a regime of flexible exchange rates is assumed to guarantee enough financial power to restore full employment (while a system of fixed exchange rates limits monetary sovereignty).

Instead, fixed but adjustable exchange rates or the elimination of any exchange rate (if price levels have sufficiently converged) are being argued for three reasons: Firstly, many of the assumptions stipulated within the framework of OCA, PPP and UIP do not hold in the real world. Further, "given the unknown level of future exchange rates, exchange rates feed on the expectation of other agents" (Moore 2006b: 414). Hence,

counter the effects on the exchange rate associated with fiscal policy (Sardoni & Wray 2007: 65-68). However, the present dissertation is exclusively concerned with monetary policy.

flexible exchange rates easily deviate from their fundamentals in the short run. Secondly, governments in a self-help regime have an incentive to unilaterally manipulate exchange rates or monetary policy. This can be done by tightening monetary policy (appreciating the currency) in the fight against inflation or conversely by depreciating the currency and stimulating exports (Moore 2006b: 414). Thirdly, the elimination of exchange-rate risks contributes to stable expectations, reduced transaction costs and thus eases trade (Flassbeck 2004: 3).

However, there is a fundamental difference between fixed (but adjustable) exchange rates and a monetary union: No matter how credible commitments to exchange rate parities are being enforced, a risk remains that a change in government or the political environment might force currency realignment. Investing in the sunk costs of a common currency will diminish these risks (Eichengreen 1993: 1330).

The following chapter will develop a perspective on these controversies.

3.2.3 A theoretical perspective on exchange rates

The neoclassical OCA theories and the notion of exchange rates being a buffer against real shocks are inconsistent:

If an exogenous shock such as an earthquake destroys most of the productive capacity of a country, it will cause inflation. According to the OCA theory, the loss in competitiveness and employment can be either compensated by flexible wages and prices, mobility of factors of production²⁶, or flexible exchange rates (since the country's currency will depreciate).

²⁶ However, it is sensible to assume that labour mobility in Europe will remain well below that of a currency area such as the United States with a common language and a federal government (Eichengreen 1993:1334).

In a neoclassical framework the real wage has to be lowered in order to restore full employment. However, if both nominal wages and prices are flexible, the real wage consequently may not adjust at all. Hence, flexibility of the real wage requires instead sticky prices or wages²⁷ (Bofinger & Flassbeck 2000: 22).

Neoclassical and new consensus economists argue that monetary policy is ineffective in *time* (see chapter 3.1). An increase in the money supply can only temporarily “fool” economic agents until prices adjust. Completely rational agents will not react to a monetary stimulus at all as they expect prices to rise in the long run. However, it is not clear why economic agents should accept a depreciation of the national currency and thus a loss of monetary value in space (i.e. higher import prices) if they do not accept a loss of monetary value in time (i.e. by demanding higher wages in response to inflation). Consequently, if there is a restriction on monetary policy in time (money illusion) it must be equally applied to exchange rate changes or monetary policy in space (Flassbeck 2001: 17).

If currency depreciations help countries to cope with competitive pressures, neutrality of money is obsolete. But even in that case governments instead of markets could still enforce exchange rate adjustments. However, competitive devaluation is subject to Keynes famous “fallacy of composition”. Although it is a rational option for a single country, it is clearly inefficient if exchange rates are devalued in many countries at the same time. “Beggars thy neighbour” becomes “beggar yourself” (as happened in response to global economic crisis between the first and second world wars) (Muchlinski 2005: 69).

While OCA theory is inconsistent, the PPP is very restrictive. In the real world not all goods and services are tradable (i.e. because of high

²⁷ Further, in a neoclassical framework the lowering of prices by producers is usually not an attainable option since competition has eliminated any profits (Griffiths & Wall 2000: 246)

transport costs). The price level across national baskets of commodities can change without affecting the trade balance (Balassa 1964; see *Appendix III*). However, why should a purely statistical phenomenon (*Balassa-Samuelson-effect*) require a change in the exchange rate if the competitive situation between countries has not changed? Further, exchange rate changes may negatively affect innovation and thus economic development. If the exchange rate offsets lower price levels that were earned with increases in productivity, it eliminates incentives for innovation (Flassbeck 2000: 13; see *Appendix III*).

However, the speculative and erratic behaviour of financial investors and currencies is the central objection against the determination of exchange rates by markets. Financial investors do not want to buy goods, but they want to make profits. Hence, even if they know that PPP will prevail in the long run, they will risk holding a currency with a higher return in the short run. Since economic behaviour is characterised by uncertainty (as opposed to probability such as the risks calculated by insurances) the long run is irrelevant for the decisions of economic agents (Moore 2006b: 13-38). Exchange rates will tend to deviate from their PPP level in the short run and cause a loss of economic welfare. Hence, necessary adjustments of the exchange rate, wages and price levels could be better enforced by monetary policy or via the domestic wage bargaining system.

In sum, if exchange rate adjustments are only needed in the case of sustained trade imbalances, PPP could be well enforced by governments or central banks. The credibility of central banks' commitment (along with capital restrictions) to enforce exchange rates enables favourable monetary policy. Consequently, only the capacity level of the economy and the trade balance limits monetary policy.

Therefore, no exchange rates are needed between economies where price levels have sufficiently converged (despite a failure to meet OCA criteria such as mobility of labour etc.). External shocks or sustained trade imbalances (because wages have either risen too much or too little in one

country) do not justify erratic exchange rates. A common currency guarantees higher leverage against financial markets (lower interest rates), reduced exchange rate risks and transaction costs. The capacity of stable exchange rates to ease trade is an important reason why even states with relatively much financial power do not leave exchange rates to the market²⁸.

Trade patterns within the EU are highly unbalanced (see chapter 6.3). EU countries with little financial power and weak social contracts usually run trade deficits. Hence, EMU is not fully explained with stabilising trade. Indeed, countries with less financial power had to sacrifice the option of devaluation of their domestic currency. Consequently, the increased leverage against financial markets offered by a common currency must have outweighed the advantages of unilateral exchange rate policy.

In contrast, in countries with a greater dependence on trade or high competitiveness such as Germany or the Benelux countries the benefits of monetary integration for easing trade must have played a decisive role²⁹.

External shocks or sustained trade imbalances in a monetary union required either a well functioning domestic social contract or compensation (i.e. structural funds) for the negatively affected region (as would be the case within a single country with strong regional disparities). If these conditions are not met and economic policies are not coordinated on a regional level, monetary union may disintegrate as nation states enjoy greater democratic legitimacy.

²⁸ Between 1998 and 2007 trade in the EU rose from 26 to 33 per cent of GDP. Empirical studies suggest that up to 3 per cent of this increase in trade can be attributed to a common currency benefiting specifically Germany (Deutscher Bundestag 2008).

²⁹ The exchange rate instability such as witnessed during the European exchange rate mechanisms of the 1980s or the Asian financial crisis in 1998 has largely affected trade (Dieter 2008: 8). However, the external dependence of South East Asian developing countries on trade is clearly more pronounced than in cases such as France.

The next chapter will illustrate real world responses to the uneven distribution of financial power and review the concept of unholy trinity critically.

3.2.4 The unholy duality: Exchange rate policy in the real world

In the real world financial power is unevenly distributed across nations and currency areas.³⁰ Financial speculation may pronounce the uneven distribution of financial power, since certain currencies enjoy more confidence among financial investors. Depending on the domestic social contract and the openness to trade, a flexible adjustment of the exchange rate may lead to higher inflation and hence restrict financial power³¹.

Therefore, central banks or governments that do not wish to leave the exchange rate to the market and who enjoy little financial power have to offer much higher real interest rates than countries with more financial power to attract foreign capital, stabilise the currency, and keep inflation under control. (UNCTAD 2004: 128).

The following examples illustrate real world responses to the current unilateral exchange rate system. The examples illustrate the stylised experiences of developing countries that serve to concisely show the conflict between little financial power and monetary sovereignty.

Unilateral Solutions: Flexible exchange rates and free flows of capital

Some emerging economies (e.g. Brazil and South Africa) have opted for the corner solution of capital account openness, high real interest rates

³⁰ Currencies do usually correspond with national borders rather than satisfying normative criteria such as stipulated within the framework of OCAs (Goodhart 2007: 99-100).

³¹ Even the monetary policy of the most powerful and independent central banks in the world such as the ECB can only be fully explained with reference to the exchange rate. While the ECB officially neglects any consideration of the exchange rate in conducting its monetary policy and operates within the largest internal market of the world, empirical tests indicate that its monetary policy reflects the exchange rate with other relevant areas such as the US (Heine & Herr 2004: 156-163).

and growth being conditioned by capital inflows to finance economic development. Developing countries usually rely on import of technology or Foreign Direct Investment (FDI). If the domestic currency is not fully convertible (restriction on capital flows), it might negatively affect the inflow of FDI (UNCTAD 2006: 205). Additionally, financial markets in these countries have not deepened enough to offer alternatives to traditional bank finance and foreign borrowing from the leading financial centres such as local bond markets (Stevens 2004: 68). However, the incoming capital flows are very often short-term financial portfolio investments. They can cause temporary growth episodes but may soon reverse and cause unstable conditions for economic development. Further, they do not translate into FDI. For example, South Africa has experienced comparatively little inward FDI despite a pronounced openness to capital flows (UNCTAD 2006: 24). FDI seems rather driven by factors such as growth of the world economy, a good infrastructure and low unit labour costs within a region with a sufficiently attractive internal market than by openness of the capital account (UNCTAD 1998).

Unilateral solution: Fixed exchange rate and free flows of capital

The opposite case of the corner solution is an irreversibly fixed exchange rate or a unilateral peg of the exchange rate (currency board; see *Appendix IV*). Argentina had opted for dollarisation of its economy between 1991 and 2002 to restrict domestic inflation and benefit from the financial power of the anchor currency (Hanke 2002: 203-222).

However, such a unilateral exchange rate policy can only succeed if the domestic conditions in the anchor and the anchoring country converge. In other words, a country with little financial power or higher domestic inflation has to bring down inflation to the same level as the anchor country. In every year where the gap between the value of the domestic currency and the anchor country is narrowed, the inflation differential has to be reduced by the same margin to avoid external disturbances. Argentina lost dramatically in export shares, after Brazil had unilaterally

depreciated the *real* and the Argentinean *peso* was overvalued. Since financial investors knew that the US Federal Reserve Bank (FED) would not support the unilateral exchange rate alignment in a self-help regime, Argentina had to finally abandon the peg (Flassbeck 2001: 33-36).

Unilateral solution: Capital restrictions

Many Asian countries instead favoured selective capital restrictions to increase their financial power and address domestic needs with monetary policy. China, for example, operates its exchange rate on the basis of managed floating. China ties its currency to a basket of important currencies while practically fixing the exchange rate to the dollar (Karwai 2007: 113). The competitive devaluation of the exchange rate stimulates export-led growth. China demonstrates that a country with a sufficiently attractive internal market can successfully operate selective capital restrictions without discouraging FDI. The outstanding export performance is not only due to the exchange rate but also to capital restrictions. Capital restrictions have secured low real interest rates and enabled Chinese enterprises to invest in their technological base to become sufficiently competitive on the world market. Hence, increased trade integration and the accumulation of foreign exchange were rather a consequence of growth than vice versa (Flassbeck, Dullien & Geiger 2005: 1-43)³².

Unholy duality

These real world examples indicate that unilateral corner solutions of the exchange rate regime do not operate well in the absence of capital

³² Recent efforts for monetary integration in Asia suggest that regionalism does not require the sequencing established in Europe where trade integration preceded monetary integration. Presently, possible welfare gains from free trade are lower since barriers to trade were markedly higher in the 1960s (Dieter 2000). Hence, eliminating exchange rate fluctuations may be a cheaper alternative for trade integration than the complex certification of products and services for preferential trade agreements (Dieter 2006: 103). Further, restrictions on trade and capital flows may circumvent destabilising effects from erratic exchange rates on the economies seeking monetary integration.

restrictions or sufficient financial power. Hence, according to Heiner Flassbeck, the unholy trinity has to be restated as *unholy duality*: In economies with little financial power monetary sovereignty and capital mobility are irreconcilable, irrespective of the exchange rate regime. Floating exchange rates are not superior to fixed (but adjusted) exchange rates in terms of monetary sovereignty. Monetary sovereignty is determined by the domestic social contract and the scope of international monetary cooperation (Flassbeck 2001: 39-43).

Monetary policy in economies with little financial power has either to be conducted on a multilateral level (fixed but adjusted exchange rates or currency unions), or capital mobility has to be restricted unilaterally. Countries with a rather unilateral tradition that can be traced to a lack of cooperation on security issues (e.g. in most Asian states) will usually favour unilateral solutions (Webber 2007: 156-159)³³. Thus, economies with little financial power and/or economies with weak social contracts have to either restrict capital flows or to opt for a multilateral solution such as currency unions.

Any financial regime has repercussions on national economies. Monetary sovereignty with flexible exchange rates is a myth, because financial power is unevenly distributed and money is an international collective good. The current self-help regime emerged after the breakdown of the US-led Bretton Woods financial system and limits countries' ability to fully use monetary policy for domestic needs. Hence, it easily translates into what Raymond Vernon labelled *sovereignty-at-bay* (Vernon 1971).

The dissertation argues that EMU should be explained with the desire of most member countries to consolidate their financial power while those

³³ However, the experience of the financial crisis in Asia has recently contributed to regional financial cooperation (Dieter & Higgott 2003: 430-455). Apparently, the collective experience of vulnerability is a serious precondition for integration efforts as witnessed in Europe after WWII.

with more financial power or a pronounced openness to trade tried to preserve favourable trade patterns.

4. Preliminary Conclusions

Eclectic state-centric realism explains European integration most adequately. A specific hegemonic environment with the US sponsoring European integration has enabled deeper European regionalism. Regionalism has been a process of bargains between nation states:

The *UK* and the *Scandinavian Countries* sacrificed national sovereignty less voluntarily. They developed a unilateral response to economic and political challenges. The UK's attitude towards European integration has been influenced by its former role of World Power and its special relationship with the United States. Continental European integration has been largely driven by *France's* security concerns and the desire to avoid constant confrontation with its rival hegemon Germany. *Germany's* approach to integration has aimed at partially regaining political sovereignty as a precondition for economic recovery. The *Benelux* and the *Southern Mediterranean Countries* had a rather functionalist approach to integration as they possess only limited relative power. They tried to gain influence by sponsoring integration and bargained their own position on specific integration issues in a very flexible manner. However, they differ markedly in their approach to market-based integration. In sum, European integration has been primarily policy-driven and only later focused on economic and monetary affairs.

Financial power defined as the ability to stimulate economic development with sufficient provision of credit is conditioned by the domestic social contract and the monetary or exchange rate regime. Robert Schrire's argument that countries and regions are differently affected by globalisation also holds true for financial markets (Schrire 2000: 49-66). From the perspective of countries with little financial power monetary

regionalism is a response to the unholy duality of monetary sovereignty and capital liberalisation.

The case study will evaluate the theoretical argument against the background of the EMU. Chapter 5 will analyse financial globalisation during the Bretton Woods financial system and illustrate early monetary responses in Europe. Chapter 6 will portray the process towards EMU and illustrate national approaches to monetary regionalism. Chapter 7 will conclude the dissertation and answer the initial research question.

University of Cape Town

Section II

Case Study

University of Cape Town

5. The history of the Bretton Woods financial system

The Bretton Woods system was the only multilateral, albeit hegemonic, system of financial governance since the emergence of financial leadership. The chapter will recapture the rise and demise of Bretton Woods in order to illustrate how financial globalisation spurred the development of EMU.³⁴

Before World War I international capital flows had reached high levels and controls on capital flows were mostly absent. The interwar period witnessed the collapse of the monetary order and the spread of capital controls accompanied by a decline in international movements of capital. The post-World War II era was governed by the Bretton Woods system and the gradual recovery of financial flows following the relaxation of capital controls. Since the collapse of the Bretton Woods financial system in 1971 high capital mobility has been restored again (Eichengreen 1996: 3).

Chapter 5.1 illustrates that financial power and leadership played a crucial role in determining domestic currency regimes even before the term globalisation had been coined.

5.1. The pre-Bretton Woods era

The bimetallic monetary order of the pre-Bretton Woods era developed into a gold standard around the 1870s. The gold standard substituted different commodity-money standards before the final advent of *fiat money*³⁵ and fractional reserve banking. Central banks only gradually secured the monopoly of money emission and became a public institution.

³⁴ The chapter draws primarily on Eichengreen (1996)

³⁵ Fiat money stands for paper money not backed by gold, convertible foreign exchange and to some extent government bonds (Eichengreen 1996: 199)

They navigated constantly between defending the gold parity and the role as a lender of last resort (Eichengreen 1996: 7-8).

5.1.1 Bimetallism

Many countries minted gold and silver coins throughout the nineteenth century (bimetallic standard). They managed the simultaneous circulation of the metals by requiring the mint to supply coins with legal tender status to the public in exchange for specified quantities of silver or gold at a fixed ratio. If the prices on the world market for these metals changed, it created incentives for arbitrage and could strip a bimetallic country of its underpriced metal (Eichengreen 1996: 10-12; see *Appendix V*).

England accidentally adopted the gold standard in that way. Silver had become underpriced at its mint and led to a huge inflow of Brazilian gold that could not be reversed by small adjustments in the mint ratio. In 1821 England finally abolished any legal tender status of silver (Eichengreen 1996: 12).

The next chapter captures the working of the gold regime.

5.1.2 The emergence of the Gold Standard

Money is a public good. It caused the complicated maintenance of bimetallism and the long transition to gold. As long as most countries circulated both metals there were advantages to maintain the same standard as the rest of the world (network externalities) (Eichengreen 1996: 13-15).

The circulation of foreign silver with different degrees of fineness led to arbitrage and a flood of less valuable money (i.e. Italian silver coins) while more valuable money (i.e. French silver) was hoarded. International agreements were negotiated for the harmonisation of silver coinage and against silver inflation. However, Britain did not wish to participate, since it

had already abolished silver from circulation, and the US with a strong agrarian silver lobby was only beginning to recover from its civil war. Germany finally shifted towards gold as its Eastern European trading partners provided only inconvertible paper currency and the financing of its foreign commerce had been financed with London-based credits denominated in British sterling. Since Germany had been a major industrial power in Continental Europe and promised more monetary stability than its adversary France, the German decision finally tipped the balance in favour of gold (Eichengreen 1996: 16-18).

In the 1880s the deflationary bias of the gold standard (too little money in circulation) became apparent. However, coordination problems were an obstacle to a return of smaller economies into bimetallism. The dangers of driving good money (gold) out of circulation (mint ratio) and eruptive exchange rate fluctuations against gold countries (inflation differentials) were too great (Eichengreen 1996: 20).

According to David Hume's *price-specie flow* model, an outflow of gold lowered domestic prices and hence balanced trade. However, actual capital movements were substantially larger than the balance of commodity trade, due to foreign lending. Further, gold shipments did not occur on a scale predicted by the model. Only the discount rate explained the real world deviations from the model. Central banks intervened by adjusting the interest rate, affecting the price level and thus avoiding an outflow of gold. However, many central banks were still private entities that tried to maximise profits with interest rates. The growth of private banking threatened the business of central banks. Too high interest rates could deprive central banks of their market. With time central banks learned how to operate OMOs and became a public institution (Eichengreen 1996: 25-27).

Barry Eichengreen argues that the discipline of gold worked so effectively, because labour was in a weak position (absence of workers' voting rights), and therefore central banks could subordinate domestic concerns to

stabilising exchange rates. Financial investors were convinced of central banks' commitments to defend gold. They rationally anticipated monetary policy quite accurately and stabilised exchange rates prior to central bank interventions (Eichengreen 1996: 31).

However, an increase in a country's discount rate would generate immediate repercussions in other countries, provoking an outflow of gold. In the absence of global coordination, the Bank of England (BOE) emerged as financial leader and other central banks adjusted their monetary policy accordingly³⁶. In several cases central banks successfully cooperated when investors' confidence in gold eroded. Central banks' commitment and temporary escape clauses saved the gold regime (Eichengreen 1996: 25-38).

In sum, fixed exchange rates and trade integration mutually supported each other. However, the gold regime in Continental and Northern Europe rested upon a lack of democratic rights and a highly unequal distribution of financial and commercial power. Countries with democratic reforms such as universal suffrage enjoyed less confidence of financial investors. The regime required a close fit between lending activity and export of capital goods in most countries of the European core (Eichengreen 1996: 42-44).

³⁶ Countries on the periphery did not enjoy the same kind of monetary solidarity. Primary producing countries were faced with large goods market shocks due to narrow production patterns and commodity exports. Britain, however, was a major producer of capital goods. Its overseas lending activity usually generated additional demand for its own production, stabilising its balance of payments. In contrast, countries on the periphery were threatened by trade deficits and capital flight. Even the US experienced monetary instability since democratisation (universal male suffrage) had undermined confidence in the commitment towards gold. Gradually, deposit money was topped on monetary gold in rapidly industrialising nations and dissolved the deflationary bias of gold. However, pressures for currency depreciation continued to plague agrarian countries such as Argentina, Brazil, Chile, Italy, Portugal and the United States. Landowners with fixed mortgages favoured inflation and exporters pressured for currency depreciation (Eichengreen 1996: 39-42).

The next chapter specifies the inadequacy of the gold regime for equitable economic expansion if domestic policy is constrained by financial investors.

5.1.3 The crisis of the Gold Standard

The crisis of the gold standard was fuelled by a shift of military and commercial power during and after World War I. The US occupied an increasingly powerful position in the international arena while the position of Britain and Continental Europe eroded.

During the war, Britain had been forced to sell off many of its foreign assets. The close relationship between foreign investment and export of capital goods loosened. Continental countries such as Germany became debtors and depended upon capital imports from the US (Eichengreen 1996: 45).

Gold fuelled the war machine, and governments prohibited gold exports. The disruption of gold market arbitrage led to floating exchange rates, which had only been limited by capital controls. The governments suspended the backing of their currencies with gold or foreign exchange and issued fiat money (Eichengreen 1996: 46-47).

The War also ended fiscal support by the US for its French and British allies. Consequently, Britain suspended convertibility. Among the major currencies only the US dollar remained convertible into gold. Hence, the first half of the 1920s was marked by freely floating exchange rates. Floating exchange rates led to erratic currency values, destabilised trade and aggravated inflation. Hence, Ragnar Nurkse prepared a very pessimistic account of a flexible currency regime to the League of Nations (Nurkse 1944) while others such as Milton Friedman traced the erratic behaviour to policy failures (Eichengreen 1996: 51-52).

Despite contending views on the sources of instability (markets vs. policy) an international consensus emerged for re-establishing the gold standard. Both those in favour of more stable exchange rates and those who lobbied for discipline in domestic politics thought that the gold standard would assist their intention. Further, the network externalities of currency regimes (public good) enabled a collective return of countries into gold (Eichengreen 1996: 57).

However, the period between the return of a record number of countries to the gold standard and its final demise (with the devaluation of the British Sterling) lasted only from 1926 until 1931. The adjustment mechanism no longer worked, and huge trade imbalances persisted. Japan and the US increasingly penetrated the markets of Latin America and Asia that had previously served as destinations for European exports. The US lent its surplus back to Europe to finance the continent's current account deficit. When the US raised interest rates to cool down its economy and defend the gold cover ratio, capital outflows depressed European economies. However, before the specie-price flow model could even operate and restore the trade balance, the Great Depression hurt European export markets (Eichengreen 1996: 48; 69-71).

The competitive devaluation of the sterling area and Central and Eastern European exchange controls eroded the payments position of the gold bloc. When the former British Empire gave up the gold cover, the tide turned. In order to defend their reserves and stand the test of the markets, gold countries applied restrictive monetary and fiscal policies, further depressing the economy and aggravating mass unemployment. Financial investors, anticipating a policy shift in response to domestic pressures, sold gold-backed currencies, which provoked an even firmer restrictive policy. Finally, the gold countries had to suspend convertibility and depreciate their currencies, triggering a new round of global mercantilism. The unilateral responses via devaluation (*beggar-thy-neighbour*) further disintegrated world trade. (Eichengreen 1996: 50; 85-87; *Appendix VII*).

In sum, three factors made a return to gold impossible: Firstly, the trade-off between external (exchange rates) and internal (domestic policy) objectives. Secondly, the changing pattern of international capital flows, which further destabilised exchange rates. Investors had lost confidence in monetary discipline. Thirdly, the trading patterns after World War I ceased to fit the international monetary order "like a hand in a glove" (Eichengreen 1996: 91).

The next chapter illustrates how the negotiations of Bretton Woods reflected the unequal distribution of power.

5.2 The Bretton Woods financial system

The Bretton Woods system differed from the gold standard in three important aspects: Fixed exchange rates became adjustable under specific circumstances (defined as fundamental disequilibrium), providing an alternative to the deflationary measures required under the gold standard. Controls on capital flows were applied and the International Monetary Fund (IMF) had been established in order to monitor national economic policies and finance countries troubled by balance of payment deficits. Further, a scarce currency clause provided sanctions (exchange and trade restrictions) against countries with a sustained trade surplus (Eichengreen 1996: 93-94).

In reality, exchange rates were rarely adjusted and the Fund's resources were too little to manage the extraordinary post-war payment problems that plagued Europe. The scarce currency clause was never applied. Capital controls worked quite efficiently even though the relaxation of current account restrictions complicated their maintenance. However, the increased relaxation of restrictions and the absence of critical adjustments put the Bretton Woods system under stress (Eichengreen 1996: 94-96).

5.2.1 The design of the Bretton Woods financial system

The negotiations at Bretton Woods were led by John Maynard Keynes (UK) and Harry Dexter White (USA). During the Bretton Woods negotiations the former financial leader UK aimed at a multilateral financial order distributing the burden of adjustment more equally among surplus and deficit countries. The United States instead tried to consolidate their position as new financial leader and trading power previously acquired during two world wars (Eichengreen 1996: 96).³⁷

The Keynes plan envisaged international money (*see Appendix VI*), fixed but adjustable exchange rates and the application of exchange and trade restrictions to reconcile full employment with payments balance. Keynes further pledged for extensive balance of payment financing subject to conditionality and penalty interest rates (penalising both abundant deficit and surplus countries measured against an index of trade). If a country had run a persistent payment surplus (as the US did in the 1930s), it would have been obligated to finance the drawing rights of other countries. White instead aimed at a world free of controls on capital and trade plus fixed exchange rates where exceptional adjustment had to be overseen by an international institution with veto power (Eichengreen 1996: 96-97).

The *Joint Statement* agreed on in 1943 reflected the asymmetric bargaining power of the two parties. The controversial positions on exchange rates discharged into an "adjustable peg". No international money was agreed on. The quotas specified came closer to White's plan (in theory requiring greater exchange rate flexibility to cope with balance of payment problems). Countries were obligated to declare par values for their currencies in terms of gold or a currency convertible in gold (which

³⁷ White "(...) was sitting on an enormous stockpile of gold that had been accumulating ever since Roosevelt had fixed the price of gold at \$35 an ounce in 1934, and he was determined to reduce it through a rapid build-up in international trade as soon as the war was over." (Boughton 2002: 13).

meant the US dollar) and to hold their currency values within 1 per cent of those levels. Par values could be changed by 10 per cent in reaction to an unspecified "fundamental disequilibrium" following consultations with the IMF, by larger margins only with the approval of three quarters of its voting power (Eichengreen 1996: 97).

However, Britain succeeded in permitting the maintenance of capital controls and authorising controls on imports from countries with persistent payment surplus (scarce currency clause). It further secured a limited period in which controls on current transactions could be maintained (Eichengreen 1996: 98). In sum, the Bretton Woods system could be labelled a "gold-dollar standard" (BMF 1977: 22).

5.2.2 The Bretton Woods financial system and trade liberalisation

The European trade deficit indicated immense unsatisfied demands for food, capital goods and other merchant products. It worsened the dollar shortage and soon dwarfed the modest quotas and drawing rights of the agreement. In response, the US extended 13 billion US dollars or four times the European drawing rights and more than six times the amount of the US obligations to Europe as Marshall Aid between 1948 and 1951 (the first years of IMF operations). In 1949 European currencies were devalued by an average of 30 per cent and import controls remained in place (Eichengreen 1996: 98).

However, the US priority was clearly on re-liberalising global trade. From that perspective extensive trade would deepen the interdependence of the French and the German economy, suppress political conflicts, prevent future wars, fuel economic recovery, and provide Europe with hard currency earnings needed to import raw materials and capital goods (Eichengreen 1996: 99). The US acceded to the monetary provisions of Bretton Woods mainly to support global trade and finalise the General

Agreement on Tariffs and Trade (GATT)³⁸. The Bretton Woods agreement prohibited restrictions on current account transaction without Fund approval and obligated countries to substantially remove monetary restrictions on trade within the first five years of the IMF's operation. However, while trade was gradually liberalised, the transitional period stretched to twice the length (Eichengreen 1996: 99-100).

Currencies in Europe would have been clearly overvalued if restrictions on trade were to be removed. Wartime inflation had been much higher in Europe than in the United States, but half of the exchange rates against the US dollar remained at their pre-World War II level. Hence, trade restrictions could only be removed without causing unsustainable deficits if currencies were depreciated (risking higher inflation due to a large share of imports in European economies) or government spending curtailed. However, while the United States argued that trade was the engine of growth, European governments identified investment as the key. Curtailing investment would not only have slowed growth but possibly caused labour unrest in Europe (Eichengreen 1996: 100-101).

5.3. European monetary regionalism during the Bretton Woods era

The return to convertibility of exchange rates in post-war Europe proved difficult, as the decision of one country to liberalise capital flows involved huge risks without the cooperation of other countries. These difficulties led to a realignment of European currencies.

5.3.1 Sterling crisis and currency realignments in post-war Europe

The British sterling had been much less overpriced in terms of inflation and war-related destruction of industrial capacity than the currencies of

³⁸ However, the subsequent US initiative for the establishment of an International Trade Organisation (ITO) failed since the US congress denied its approval. The Congress feared that the ITO would endanger national economic sovereignty (Kenen 2000: 376).

Continental European countries. However, since Continental Europe maintained high tariffs and quantitative restrictions, the scope for export revenues that would support a convertible currency was limited. (Eichengreen 1996: 102-103).

However, in 1947 the US insisted on Britain restoring current account and hence currency convertibility in exchange for a loan. Washington was anxious about imperial preference and keen to penetrate the markets of the UK and the Commonwealth. Further, the US saw British convertibility as an important step towards an open trading system. The effects were disastrous: The loan that had been allocated to last till the end of the decade was exhausted in a matter of weeks and convertibility suspended within a month with American consent (Eichengreen 1996: 103-104).

Subsequently, the US accepted stretching out the transitional period of discrimination against trade and capital flows in Europe and mobilised huge capital aid (Marshall Plan). The problems were not limited to Britain as capital flight in France, Italy and Germany posed threats to political stability. Additionally, between 1948 and 1949 a recession in the US widened the European trade deficit. Consequently, in 1949 the sterling area had to devalue again and impose capital restrictions. Thirty additional countries, with the exception of Switzerland, Japan and some Latin American and Eastern European countries, had to devalue in response to the sterling crisis (Eichengreen 1996: 105-106).

The devaluations had the desired effects. The end of the US recession and the beginning of the Korean War in 1950 further eased the pressures on European current accounts. However, European trade deficits against the US remained severe while intra-European trade linkages kept low and required additional monetary measures (Eichengreen 1996: 106).

The next chapter illustrates how the deficiencies of the Bretton Woods system contributed to European monetary cooperation.

5.3.2 The European Payment Union (EPU)

The EPU was created in 1950, initially for two years, to deal with Europe's trade and payment problems but eventually lasted until 1958. The EPU resembled the Bretton Woods agreement on a regional level while consciously discriminating against the United States. The creation of EPU and its discriminatory mandate meant that the asymmetric system of Bretton Woods was officially acknowledged (Eichengreen 1996: 106-107).

The EPU aimed at restoring current account convertibility³⁹. Additionally, it entailed a credit device to adjust for balance of payment disequilibria. Polster argues that in that sense EPU was more than a means to achieve trade integration. It bore the potential for closer monetary integration (Polster 2002: 96).

The US acceded to the discriminatory policies of the EPU, securing Western European support in the Cold War against the Soviet Union (Eichengreen 1996: 108). However, the potential for EPU to become a cornerstone of monetary integration split the US administration. Whereas the Treasury Department feared monetary emancipation of Western Europe from the IMF, the Economic Cooperation Administration (ECA) and the State Department saw European monetary integration as a potential force for a neo-capitalist new deal (Polster 2002: 99).

The initial concept of EPU was inspired by the symmetrical Keynesian Clearing Union⁴⁰ and aimed at a pooling of European currency reserves under a supranational umbrella. The trade surplus of creditor countries

³⁹ Convertibility meant enabling private transactions within the "real economy" (commercial convertibility). It required import licensing in order to ensure that foreign exchange was used for that purpose. Pure capital transactions were certainly not allowed. Britain lobbied further for foreigner convertibility (foreigners being allowed to exchange foreign currency into Sterling), hoping to thereby strengthen the reserve currency position of the UK (Polster 2002: 108).

⁴⁰ However, this time the British administration was opposed to the idea of a supranational currency. Britain feared that the status of sterling as second most important international reserve currency could be potentially undermined (Triffin 1962: 164).

was to be compensated with gradually diminishing gold and dollar reserves while the deficits of debtor countries had to be paid with increasing amounts of gold and dollars. The remainder had to be financed through generous credits from the reserve pool and hence the creditor countries.

However, the European countries were split into two camps based on their (presumptive) future creditor or debtor position (degrees of financial power). Belgium led the camp of potential creditors while the UK and Scandinavian countries defended the cause of debtors. Germany had been a debtor initially, but adjusted its position as soon as the country became a creditor (Polster 2002: 100-101).

The German shift was astounding, since the country had only previously exhausted its quotas due to higher prices for imports of raw materials during the Korean War. According to the rules of EPU it would have had to leave the arrangement. However, the directorate of EPU, which had accrued fewer competencies than initially intended due to US reservations, managed an extraordinary rescue of the German economy. It allowed Germany to unilaterally re-impose trade restrictions and granted a credit by EPU. These measures helped Germany to surmount the crisis, and the country only then shifted to permanent surplus within EPU (Polster 2002: 116; Eichengreen 1996: 110-111).

The symmetrical concept did not succeed: The US, not the European countries, provided the capital for the credit mechanism. Creditors exceeding their quotas (15 per cent of 1949's trade volume) were compensated with constant non-diminishing amounts of gold and dollars. The mechanism was gradually revised in favour of creditor countries. Anyhow, the mechanism entailed an automatic credit to finance deficit countries' imports (the remainder not covered by dollars and gold). Absolute symmetry was unrealistic as some countries were creditors within Europe but in a debtor position towards the rest of the world. Further, the EPU was multilateral in the sense that countries were in

surplus or deficit against the union as a whole and bilateral obligations ceased to exist (Polster 2002: 106-107).

The EPU code of liberalisation mandated restoring convertibility of currencies for purposes of current account transactions. In 1951 all existing restrictions were to be equally applied in a non-discriminatory manner among EPU members, and they were to reduce their tariff levels gradually by one half and then by 75 per cent. When the EPU was terminated, credits amounting to over 3 billion US dollars were outstanding; equivalent to an increase in the Bretton woods quotas of nearly 50 per cent. (Eichengreen 1996: 107).

The Bretton Woods institutions gradually lost relevance in comparison to the EPU. Europe had been the largest debtor of the World Bank in the first seven years of its existence. However, the World Bank's total European commitments amounted to only slightly more than five per cent of US aid commitments during the period of the Marshall Plan. IMF drawings were scarcely larger during the same period and the Fund had acceded to US demands to withhold finance from countries that received Marshall Aid to ensure American control over European financial affairs (Eichengreen 1996: 108).

Democratisation and the consolidation of labour power prevented European countries from subordinating monetary sovereignty (interest rate policy) under external balance considerations as had been the case during the gold standard. Hence, the only instrument left to ensure balance of payments adjustment were exchange controls. These controls were rendered acceptable for EPU members, since they were subject to EPU approval and applied in a non-discriminatory manner across Western Europe (Eichengreen 1996: 110-111).

However, despite the relative success and the weakening of the IMF, EPU did not become a device for closer monetary integration. Firstly, although commercial convertibility was successfully restored, political integration

lagged behind. As a response to the crisis of integration, the group of six established the EEC. In 1955 the European Monetary Agreement substituted EPU. Secondly, the IMF began to relax its credit policy to debtor countries in order to regain ground lost to EPU (Polster 2002: 123).

The next chapter illustrates the decay of the Bretton Woods financial system and the rise of financial globalisation.

5.4 The demise of the Bretton Woods financial system

The EPU contributed to Europe's economic recovery and, in interplay with US military expenditure and foreign aid, diminished the United States' surplus. In 1958 European countries had restored convertibility as laid down in Article VIII of the Bretton Woods agreement (Eichengreen 1996: 113-114).

However, a system of fixed exchange rates with free flows of capital and no exchange rate adjustments required credit to finance imbalances or restrictive monetary policies. Hence, weak-currency countries lobbied for more generous IMF quotas and additional international reserves while strong-currency countries objected to these demands (Eichengreen 1996: 114).

The Bretton Woods system had been designed asymmetrically with the US dollar being the lead currency providing international liquidity. Governments and central banks supplemented their gold reserves with US dollars and thereby added to US liabilities towards the rest of the world. This put pressure on the dollar-gold parity. The US could limit its liabilities by raising interest rates, thus making acquisition of the US dollar more expensive. On the other hand, a loose monetary policy provided more liquidity for the international markets. Either way the system relied on domestic economic policies in the United States (Eichengreen 1996: 115).

The scarce currency clause providing foreign exchange for deficit countries had been designed to compensate these asymmetries. However, as the US consolidated its lead currency status, the system became ever more asymmetrical (*Triffin Dilemma*). The significant rise in global trade, the concerns of industrial countries about a future shortage of US dollars in the event of a US surplus, and developing countries' pressure enabled the agreement on special drawing rights (SDRs) (see *Appendix VIII*).

By the time the US had achieved temporary payment surplus and SDRs were applied, dollar inflation had already gained ground with the development of oil-backed Euromarkets. The Triffin Dilemma persisted: The more the dollar became lead currency, the more speculations arose as to whether the United States could defend gold parity⁴¹. (BMF 1977: 52; Eichengreen 1996: 117; 119-120).

5.4.1 Trade integration and monetary disintegration

Capital controls had a distinct impact on interest rate differentials and hence foreign exchange transactions (Eichengreen 1996: 121). The gradual removal of trade restrictions implied a loosening of capital controls (current-account convertibility) and contributed to the erosion of monetary sovereignty (Eichengreen 1996: 120-121).

⁴¹ The French President De Gaulle had been a prominent critic of America's "exorbitant privilege" and threatened to liquidate French dollar reserves. The French position reflected that Paris never established itself as a financial centre comparable to London or New York and hence the franc never came close to being an international lead currency (with the exception of its regional position in the former colonies of West Africa) (Eichengreen 1996: 115-116).

Another important catalyst of financial globalisation was the development of *Euromarkets*. The convertibility of current accounts eased the acquisition of foreign exchange. However, the mounting pressures on the US dollar (e.g. due to inflation caused by increased military expenditure for the wars in Korea and Vietnam) forced the United States to apply an interest equalisation tax to keep the domestic interest rate level under control. Since foreign depositors already held considerable amounts of US currency abroad and capital controls at the U S border were less effective, Euromarkets took stage. Financial investors began to deposit US dollars in the City of London as they achieved higher interest there. Further, the dollar-dominated oil revenues from states within the Organisation of Petroleum Exporting Countries (OPEC) were increasingly recycled through London (BMF 1977: 26-27).

When capital controls eroded, the only option to keep the Bretton Woods system going were currency realignments and restrictive monetary policies. However, monetary authorities rarely realigned currencies. Surplus countries feared the erosion of competitive advantage while deficit countries were concerned about information leaking from the IMF to financial investors (Eichengreen 1996: 122). The latter might have fuelled further destabilisation of exchange rates and thus bore the risk of overpricing imports and contributing to inflation. Instead, restrictive monetary policy required slowing growth and weakening the domestic social contract (which effectively happened after the Bretton Woods system had been abolished).

5.4.2 The suspension of Bretton Woods

During the Bretton Woods era the dollar-gold parity had to be adjusted several times in favour of gold. The US enforced selective capital controls, but opposed a more symmetrical financial system. Bretton Woods only survived for so long because monetary authorities cooperated (e.g. by pledging to refrain from converting dollars into gold or purchasing US bonds) (Eichengreen 1996: 124; 130). Foreign governments supported the

dollar and reluctantly stimulated merchandise imports, because the US threatened to disrupt the trade and monetary system and bore a disproportionate share of the defence burden (Eichengreen 1996: 128-130; 135).

However, there were limits to international cooperation. Countries with rising financial power such as Germany feared importing US inflation by backing the dollar. Germany realigned its currency only modestly to preserve the trade surplus. France, on the other hand, recalled the refusal of other countries to assist its own military ventures. The military undertakings in Southeast Asia were less important to Western Europe than protection by the NATO (Eichengreen 1996: 130-132; 135).

In 1971 Germany, joined by the Netherlands, refused to intervene on behalf of the US dollar and allowed the Deutsche mark to float upwards. Speculations emerged about France and Britain converting dollars into gold. The Nixon administration in the US closed the gold window by suspending its commitment to provide gold to foreign dollar holders and imposed a 10 per cent surcharge on merchandise imports to pressure other countries to realign their currencies. These developments motivated the Smithsonian agreement and the revaluation of the yen, the Swiss franc, the Deutsche mark and the Benelux currencies (Eichengreen 1996: 133).

US corporate competitiveness was restored, but the underlying fundamentals remained unchanged. Britain also faced inflationary pressures as the fragmented union movement hindered collective wage bargaining, and the governments did not wish to apply restrictive monetary policies. Sterling was the second most important reserve currency and the psychological line of defence for the US dollar. In 1972 Britain floated the sterling outside its Smithsonian band. The dollar was devalued once again by 10 per cent and by a larger margin against the yen. However, capital flight continued. Germany and the rest of the EEC jointly floated their

currencies upward. The Bretton Woods financial system (albeit never officially suspended) ceased to exist (Eichengreen 1996: 125; 134).

In sum, Eichengreen argues that four lessons could be drawn from the period of Bretton Woods: Firstly, capital liberalisation complicates exchange rate policy. Secondly, the hegemonic financial system and monetary cooperation required a political alliance between the United States, Western Europe and Japan. Thirdly, a cooperative monetary system will work most efficiently if it belongs to an interlocking web of political and economic bargains. Fourthly, if relative power and political objectives of the states involved change, cooperation may run up against binding limits (Eichengreen 1996: 135).

The following chapter argues that the same holds true for European monetary regionalism.

6. European monetary integration in the post-Bretton Woods era

In 1962 the Commission of the European Community drafted a first plan for a fully-fledged monetary union to be achieved within nine years. The sole accomplishment of that initiative was the committee of central bank governors, which did not develop an operational role until the breakdown of the Bretton Woods financial system. (Eichengreen 1993: 1323).

Two important developments spurred later European monetary integration: The breakdown of the Bretton Woods financial system and the Single European Act (SEA). As intra-European exchange rates were effectively pegged by their parity commitment to the US Dollar, pressure for exchange rate coordination had been minimal during the Bretton Woods era. Once the crisis of Bretton Woods became tangible, these pressures intensified. The SEA finalised a truly internal market for commodities, capital and (with some limitations) labour by 1992 (Eichengreen 1993: 1324). Eichengreen argues that trade integration did not necessarily require monetary unification. However, since unbalanced trade patterns

could potentially exacerbate huge exchange rate swings, floating exchange rates bore the risk of intensifying opposition to the single market. He suggests that only in that political sense was monetary unification a necessary corollary of trade integration (Eichengreen 1993: 1322-1323; 1327-1331).

The various initiatives towards EMU⁴² differ markedly in respect to the regulation of capital flows and the concept of European economic governance. They illustrate the change of political concepts and relative power that occurred within the EU since the end of Bretton Woods. (Eichengreen 1993: 1323).

The Hague summit in 1969 appointed a committee, chaired by the then Prime Minister of Luxembourg, Pierre Werner, which recommended monetary union within ten years (*Werner Plan*). The Werner Plan was in many respects the most ambitious and symmetrical initiative towards EMU. It envisioned three stages: The first stage recommended limiting exchange rate fluctuations and coordinating fiscal and monetary policies. The second stage called for a further reduction of exchange rate variability and a narrowing of price divergences. The third stage proposed irrevocably fixed exchange rates and the removal of capital controls. An EC system of central banks (comparable to the US Federal Reserve System) would take control of monetary policies in the member countries. The size of the EU budget would be dramatically increased and fiscal policies would be coordinated. However, the Plan did not recommend a monetary union, but suggested that both options (fixed exchange rates or single currency) were viable (Eichengreen 1993: 1323).

Elements of that report were implemented in 1972 when EC countries introduced a mechanism commonly labelled *the snake*. The latter limited

⁴² The dissertation will only portray the most relevant initiatives, ignoring some of the transitional developments that were only technically relevant, such as the European Monetary Agreement between 1958 and 1972.

bilateral exchange rate movements to 2 ¼ per cent bands. However, policy coordination lagged behind. The first OPEC oil shock hit the European countries asymmetrically (an expression of unequal financial power and different social contracts among the EC members), resulting in varying degrees of mass unemployment and contradictory policy responses. The oil price shock led to wider revaluations of currencies than intended under the snake and some countries left the mechanism temporarily or even permanently (Eichengreen 1993: 1323).

These developments led to the exchange rate mechanism negotiated at the Bremen summit in 1978: the *European Monetary System (EMS)*. The EMS was less ambitious than the Werner Plan. It sacrificed the idea of policy coordination and allowed different exchange rate bands for EC countries within the *Exchange Rate Mechanism (ERM)* as well as currency realignments in response to balance of payment disequilibria. Selective controls were permitted on capital account transactions (Eichengreen 1993: 1323-1324).

In 1986 the EC members initiated the SEA, committing themselves to an integrated market with free movement of commodities, capital and labour. The initiative was a (microeconomic) response to integration setbacks and the limitations of macroeconomic policies in a global self-help regime. Thus the SEA was a decisive turning point towards institutionalised neo-liberalism in Europe. In 1988 it led the European Council to appoint a committee, chaired by Jaques Delors, then President of the European Commission, to evaluate the prospects of monetary union (*Delors Report*). The recommendations of the Delors Report were published in 1989 and provided the framework for intergovernmental negotiations in 1991. The Maastricht Treaty incorporated many of the conclusions from that report (Eichengreen 1993: 1324).

The Treaty of Maastricht amended the European primary law embodied in the Treaty of Rome. Capitalising upon the Delors Report, it described a monetary union to be achieved in three stages:

Stage one implied the removal of capital controls (to a large extent achieved in 1990), the reduction of inflation and interest rate differentials and stabilising intra-European exchange rates. Further, member countries had to strengthen central bank independence and bring domestic laws into conformance with the Treaty. However, convergence of inflation and interest rates proved difficult. A foreign-exchange market crisis in 1992 led to the emergency application of selective capital controls (Eichengreen 1993: 1326).

Stage two started in 1994 and was characterised by further convergence of economic indicators as well as the creation of the European Monetary Institute (EMI). EMI had to coordinate member countries' monetary policies in the transitional period of EMU. If the Council of Ministers decided by qualified majority that most countries met the criteria for monetary union, it could recommend to the Heads of States to inaugurate stage three (also by qualified majority), thereby intensifying pressures on the "underachievers"⁴³.

Stage three could have proceeded with a minority of EC countries. It fixed exchange rates irrevocably and substituted EMI with the ECB assuming control of the monetary policies of the participating countries. The Council of Ministers would decide when to replace national currencies by a single currency (Eichengreen 1993: 1326).

The single currency euro was introduced in 1999 (as mere transaction currency) in eleven member countries and as physical money throughout 2002. It is currently the official currency or anchor currency in 22 countries, of which 16 are members of the EU (European Union 2008).

⁴³ The Treaty required the EC Heads of States to meet no later than by the end of 1996 to assess qualifications for monetary union and to decide upon the start of stage three. If by

The initiatives for EMU highlight distinct conceptual approaches towards monetary unification. The Maastricht Treaty and the Delors Report resembled the Werner Plan in that they intended to achieve monetary union in less than a decade, stressed the need for fiscal harmonisation and described transition in three stages. However, they also differed in several ways:

The Werner Plan saw capital liberalisation at the end of monetary unification while the Delors Report started with liberalising capital flows. Further, the Delors Report did not propose transferring fiscal sovereignty to the EC but developed guidelines to monitor “fiscal discipline” and exclude access of member countries to central bank credit.

The Delors Report recommended monetary centralisation, transferring national central banks into operational branches of the ECB. The Werner Plan had allowed for mere monetary coordination instead. Finally, the Delors Report stressed the priority of price stability by monetary means (2 per cent inflation target). It subordinated other goals of economic policies, such as growth and employment, to price stability (Eichengreen 1993: 1324-1325).

6.1. The road to European Monetary Union (EMU)

The following chapters will outline the stages towards EMU in more detail and portray the national policies involved. The developments after the Maastricht Treaty will be ignored. Up to now only minor adjustments to that treaty have been pursued⁴⁴. It remains the cumulative stage of EMU. Neither the Treaty of Amsterdam, nor the failed TEC or the Treaty of

the end of 1997 no date had been set, stage three automatically would have commenced in 1999 (Eichengreen 1993: 1326).

⁴⁴ For example, allowing for slightly more flexibility with respect to budget deficits in case of negative growth (Council of the European Union 2005). However, such adjustments still do not tolerate anti-cyclical fiscal measures in advance of economic downturns.

Lisbon (yet to be ratified by all EU member states) introduced significant changes to the Maastricht concept.

6.1.1 The Snake

The crisis of Bretton Woods and the inadequacy of the European Monetary Agreement (EMA) from 1958 to ensure further economic and political integration forced European countries to reconsider an exchange rate mechanism. As the Smithsonian Agreement had allowed for currency fluctuations within a band of (plus/minus) 2 ¼ against the dollar, European currencies could theoretically fluctuate within a band of 9 per cent and hence threaten closer integration. Despite the shortcomings of Bretton Woods, countries with little financial power continued to lobby for regulated exchange rate policies while countries with considerable financial power such as Germany tended towards floating exchange rates (Polster 2002: 164-166).

In 1972 the central banks of the group of six belonging to the EEC agreed in Basel to limit fluctuations to 2 ¼ per cent respectively (a larger band than regulated by the initial provisions of Bretton Woods) and introduced short-term financing for deficit countries. The European countries still adhered to the Bretton Woods agreement fixing the parity to the Dollar. Hence, the Basel Accord has been dubbed the “snake (European band) in the tunnel” (Dollar parity). In 1973 the “snake left the tunnel” when European countries began to float their currencies en bloc (Polster 2002: 166). Denmark, Ireland and the UK (which joined the EC in 1973) as well as Norway and Sweden agreed to participate in the snake (Eichengreen 1996: 154).

The snake introduced an autonomous intervention mechanism. It obligated both creditor and debtor countries to intervene with unlimited amounts of European currencies to defend the band, but only within a short time frame. However, the balancing would occur in the creditor currency – if possible – and had to be compensated with an average of the

discount rate of the countries involved. Hence, it laid the burden of the parity commitment on the debtor country. A European Monetary Cooperation Fund (EMCF) initially administered the interventions on the basis of a European Currency Unit (ECU)⁴⁵. Its practical relevance fell short of the initial plans (pooling of reserves, supranational decision-making body) (Polster 2002: 166-167).

The prospects of the snake remained unclear, as the 1969 plans for monetary union had not yet failed. The process towards EMU finally stalled over a controversy among French "monetarists"⁴⁶ and German "economists". The latter argued that a political union should precede monetary integration while the monetarists pressured for supranational monetary institutionalisation (Polster 2002: 167-168).⁴⁷ The controversy was revealing with regard to the interplay of financial power and broader political priorities of the countries involved: The smaller Benelux countries Belgium and Luxemburg (who had pursued a bilateral monetary union since 1946) and the European Commission sided with France while the Netherlands and, to a certain extent, Italy sided with Germany. On first sight it is not obvious why Italy, a country that then had the highest rates of inflation and the weakest currency among the EC members, joined the economists. It appears that Italy tried to capitalise on its historical relations with Germany and maintain a flexible approach to monetary integration, since the negotiations over regional structural funds began to gain momentum (Polster 2002: 314).

⁴⁵ To be later replaced by the European Currency Accounting Unit (Polster 2002: 167).

⁴⁶ The term should not be confused with monetarism. To the contrary, the French monetarists strongly argued in favour of discretionary monetary policies.

⁴⁷ Ironically, today the dominant positions in the two countries have shifted with German policy makers strongly arguing against complementing the monetary union by economic governance (see chapter 6.2). However, the German reservations of that time were presumably of a tactical nature in order to avoid deeper monetary integration. Conversely, the French administration has been quite reluctant to complement intergovernmental economic governance by strengthening the role of the European Parliament (Polster 2002: 309).

The OPEC oil price shock affected all European countries participating in the snake. However, different degrees of financial power, oil dependency and stability of the domestic social contracts affected the participants asymmetrically. Germany targeted monetary aggregates aggressively and established the Deutsche mark as unchallenged regional lead currency while France adopted expansionary fiscal policies. The supranational capacities for coordinating the economic policies within the EC as recommended by the Werner Plan remained totally underdeveloped (Eichengreen 1996: 155; 159). At the end of the 1970s the snake was reduced to a small bloc of hard currency countries, namely Germany, the three Benelux states and Norway (Bofinger & Flassbeck 2000: 5). As from 1976 France withdrew from the snake entirely. However, speculative capital flows and erratic exchange rates reduced the support for floating even in Germany (Eichengreen 1996: 159).

Consequently, a renewed impetus for EMU had to address the French concern for a more institutionalised approach and the German priority on fighting inflation (Polster 2002: 169). The subsequent EMS satisfied these criteria.

6.1.2 From the European Monetary System (EMS) to monetary union

Formally, the EMS was a symmetrical agreement strengthening the oversight powers of the Monetary Committee of the EC and authorising governments to draw unlimited credits from the very short-term financing facility (VSTF) (Eichengreen 1996: 160).

The French initiative for deeper monetary regionalism depended on the German support by then chancellor Helmut Schmidt. Schmidt saw the creation of the EMS as a political tool to realign France with the EC after it withdrew from the snake and to insulate the German economy from the depreciating dollar. (Eichengreen 1996: 161). Hence, closer monetary regionalism was clearly a hegemonic project.

The Schmidt-Giscard initiative sought the European Monetary Fund (EMF) to manage the combined foreign-exchange reserves, intervene in currency markets and to create the European Currency Unit (ECU) as European SDR. The EMF replaced the European Monetary Cooperation Fund (Eichengreen 1996: 161).

The Bundesbank Council was concerned that the EMF might create unbacked ECU reserves in favour of deficit countries and hence undermine price stability. It therefore objected to the Schmidt-Giscard initiative. Consequently, the French and the German governments retreated from transferring national foreign exchange to the EMF. The Bundesbank reserved itself the right to opt out of its intervention obligation if the European countries failed to realign their currencies (Eichengreen 1996: 162). The participating countries agreed on the EMS in 1978. The EMS was based on an Exchange Rate Mechanism (ERM) holding currencies within a (+/-) 2¼-percentage band (for the Italian lira of 6 per cent respectively) similar to the provisions in the final years of Bretton Woods. It allowed for capital controls and currency realignments (Eichengreen 1996: 163).

The formal symmetry of the EMS implied that when a currency A reached its upper intervention point vis-à-vis currency B (i.e. it depreciated), currency B reached its lower intervention point obligating both central banks to intervene on the currency markets. In practice the system was not symmetric, because it was conducted on a bilateral basis and the VSTF credit had to be repaid by the weak currency country, effectively imposing a budget constraint. Further, the ECU's role remained limited as realignments were conducted on a bilateral basis. The informal *indicator of divergence* complemented the parity grid and obligated countries to intervene if their currency deviated from the average of all other currencies. Thereby also strong currency countries would have been forced to adjust. However, the indicator of divergence remained a purely informal provision (Bofinger & Flassbeck 2000: 9; see *Appendix VIII*).

6.1.2.1 The early years of the EMS

In its first four years the EMS was doomed by a global recession aggravated by monetarist economic policies in the US and Europe. The recession magnified policy divergences. The new French Socialist government led by Francois Mitterrand initiated expansionary policies. The policies were quite successful in terms of stabilising growth and employment. However, the Bundesbank raised interest rates, provoking capital flight from Germany to France. However, the French government refused to devalue the franc, reflecting its desire to strengthen the role of the currency as an international reserve currency and its unwillingness to stigmatise the new government domestically. Finally, the French government scaled back its policies of demand-stimulus and devalued the Franc in order to avoid a French exit from the EMS. The latter could have implied a withdrawal from the EC since huge exchange rate variations potentially undermined the CAP with fixed prices for agricultural products (Eichengreen 1996: 165-166; Bofinger & Flassbeck 2000: 3). The French policy shift was a turning point for Germany's policy makers' attitude towards EMU (Polster 2002: 420). Exchange rate adjustments became less frequent at the end of the 1980s as the gradual relaxation of capital controls complicated orderly realignments (Eichengreen 1996: 165).

The macroeconomic constraints imposed on countries with little financial power, high unemployment rates and a depreciating US dollar encouraged European policy makers to ensure global competitiveness through microeconomic reforms of the labour market and social security systems. The initiative for the SEA accelerated monetary integration. The elimination of currency conversion costs and the abolishment of the opportunity for competitive devaluation were seen as a mechanism to defuse protectionist opposition to trade liberalisation (Eichengreen 1996: 168). In 1988 the Franco-German Security and Defence Council as well as the Economic and Financial Council were established (Polster 2002: 339). These seemingly unrelated areas were to define the Franco-German compromise on monetary integration. The Delors Report and the

Maastricht Treaty stipulated the need for a single currency to finalise a truly internal market. The Delors Report implied major conceptual shifts in monetary integration. It recommended the liberalisation of capital flows as a prerequisite, not a consequence of monetary unification (Eichengreen 1996: 168).

Interestingly, the German Minister of Finance welcomed the initiative, whereas the German Foreign Minister, Hans-Dietrich Genscher, was critical. He proposed a trade-off between a monetary union and closer political integration that would assist Germany in consolidating its political sovereignty (Eichengreen 1996: 169). Subsequently, France acceded to German reunification in exchange for a German commitment to EMU. Germany accepted the irreversibility of monetary union in exchange for the ECB adopting the monetary concepts of the Bundesbank. Finally, France too agreed to closer political integration as a means to hedge against German policy after Germany's reunification in 1990. Reunification promised a huge increase in Germany's political sovereignty and the penetration of Eastern European markets by German exports. Hence, the consensus for EMU can be understood as a trade-off between Germany's desire for greater political sovereignty (both national sovereignty and within the EU's framework) and the French pursuit of monetary regionalism. (Polster 2002: 339-341).

The Maastricht Treaty of 1992 brought huge institutional changes to the EU with implications for foreign and monetary policies. In monetary affairs the Treaty of Maastricht set the stage for liberalising capital flows and irrevocably triggering EMU. Further, the treaty established four convergence criteria for EC member countries that wished to introduce the single currency: Firstly, the country was obligated to hold its currency within the ERM fluctuation bands for at least two years. Secondly, for the preceding twelve months it had to keep inflation within the range of 1.5 per cent above the rates in the three lowest-inflation member states. Thirdly, the public debt and deficit ratio to GDP had to be kept within a 60 and 3 per cent range respectively. Fourthly, the participating countries had to

maintain a nominal long-term interest rate that did not exceed the rates in the three lowest-inflation member states by more than 2 per cent (Eichengreen 1996: 171). While stabilising exchange rates, converging price levels and narrowing interest rate differentials had been clearly a prerequisite for an orderly monetary union, the adequacy of the fiscal provisions and the levels at which exchange rates were finally fixed were disputed. From the perspective of low inflation countries these provisions were the price countries with less financial power had to pay to reap the benefits of a hard currency.

6.1.2.2 The EMS crisis

The intergovernmental conference of Maastricht had been concluded in December 1991 after the EMS had endured a period of stability with no exchange rate adjustments of ERM currencies for five years. All member states of the EC except Greece and Portugal were participating. The stability could be maintained despite major economic challenges: The collapse of the Soviet Union affected European economies such as Finland that heavily exported to the East. The aid for Eastern European economies strained structural funds and cohesion programmes within the EC. Finally, Western Germany's economic and monetary unification with the GDR (with a highly disputed currency conversion ratio at par) led to budget deficits, capital imports and continent-wide upward pressure on interest rates. However, the US dollar depreciated further against the Deutsche mark and other ERM currencies. It aggravated one of Europe's deepest recessions after WW II. Despite these obstacles, no exchange rate realignments were conducted. Also countries outside the EMS – except Finland - speculating on joining the arrangement (Austria, Norway and Sweden) kept their exchange rates stable.

The turning point came with the Danish referendum in June 1992 rejecting the Maastricht Treaty and the approach of the French referendum in September of the same year. The markets subsequently tested the commitment of weak currency countries such as Italy to obey to the

narrow band (which Italy had applied in 1990). The currencies that operated within a wide band (British sterling, Spanish peseta and Portuguese escudo) weakened considerably. The sterling fell to its floor, the lira fell through it subsequently and the Finnish markka's unilateral ECU peg was abandoned. The pressure on the Swedish krona intensified, forcing the Riksbank to raise interest rates. A devaluation of the lira (widely considered as being too small) and a revaluation of other ERM currencies of 3.5 per cent intensified speculations over the stability of the EMS. Additional pressures mounted on Britain, Spain, Portugal and Italy, forcing interventions, interest-rate increases, and depleting reserves. Britain suspended its ERM membership in September and Italy floated the lira (Eichengreen 1996: 172-173).

The British and Italian exit from the ERM had contagious effects. France, Denmark and Ireland came under speculative attacks by financial investors despite the French electorate confirming the Maastricht Treaty and economic fundamentals that did not justify exchange rate realignments. Spain, Portugal and Ireland had to re-impose capital controls. Sweden subsequently abandoned its unilateral ECU peg (later to be followed by Norway) while Spain and Portugal had to devalue their currencies. The French franc could be successfully defended while Ireland's removal of capital controls in 1993 pushed Irish market rates to triple-digit levels (Eichengreen 1996: 173-174).

The Danish electorate endorsed the Maastricht Treaty in a second referendum and the Bundesbank lowered interest rates. Subsequently, the French franc and other weak ERM currencies stabilised. However, French inflation ran below German inflation. French policy-makers speculated that the franc had assumed a lead currency status and pressured the Banque de France (BDF) for interest rate cuts to fight unemployment. However, the German government refused to equally lower interest rates and to coordinate monetary policy with France, pushing the franc again towards its ERM floor, making bilateral intervention necessary. The Belgian franc and the Danish krone swiftly followed the franc. In the last weekend of July

1993 an ad hoc meeting of ministers and central bankers was called (before an impending reopening of the Tokyo stock exchange) to manage the crisis. The French government refused to further devalue the franc, a group of countries opposed general realignment of ERM currencies, the Dutch vetoed a floating of the Deutsche mark (which served as an anchor for the Netherlands) and a Belgian proposal for tighter deposit requirements on banks' open foreign currency positions (effectively limiting financial speculation) was vetoed. The disagreement led to a huge widening of the ERM band to 15 per cent (Eichengreen 1996: 174-175). Managed floating was back.

The sources of the EMS crisis are the subject of an intense debate. Some observers argue that the move of the UK, Italy and Spain towards the hard EMS was premature, since inflation differentials were too high⁴⁸. However, quantitative data suggests that only Italy (and Germany in the period after reunification) endured a significant rise in unit labour costs. Further, currencies moved suddenly to the edges of the ERM bands with no indication of a gradual decline of investors' confidence (Eichengreen 1996: 176-177).

Another explanation features expectations of future policy shifts in light of Germany's brief period of inflation. As the Bundesbank obviously rejected continuing inflation in Germany, the adjustment had to be borne by the other ERM countries slowing inflation. Hence, investors would have tested the commitment of countries with high unemployment and weak governments after the Danish electorate refused the Maastricht Treaty.

⁴⁸ Peter Bofinger and Flassbeck argue that Germany's restrictive monetary approach and Italy's reckless policy errors triggered the crisis. The lira would have been considered a more stable currency after having joined the narrow band, hence reducing the currency's risk-premium. Italy would have set interest rates too high to follow the German lead while the inflation differential remained considerable. The subsequent inflow of hot short-term capital anticipated a subsequent outflow. Hence, Italy should have narrowed the band only after disinflation policies would have reduced inflation differentials. Further, the asset settlement obligation of the VSTF should have been suspended temporarily during the crisis, enabling a more symmetrical adjustment (Bofinger & Flassbeck: 16 – 20)

But if the fear of an expansionary policy shift drove (rational) investors' behaviour, it should have been reflected in forward rates of ERM currencies immediately after the referendum (currencies appreciating signalling a future depreciation). However, the only currencies that fell out of their band prior to September 1993 were the lira and the Danish krone (Eichengreen 1996: 179).

Eichengreen suggests that financial investors capitalised on the Danish blow to Maastricht by pursuing a self-fulfilling prophecy. One country's rejection of austerity policy would have raised the political price of defending parities in other countries with sound economic fundamentals. Hence, investors would have simply speculated that after the Danish referendum domestic policy makers were less capable of ensuring support for the Maastricht Treaty once their currency was under attack. (Eichengreen 1996: 180-181). However, the relaxation of capital flows clearly invited investors to test states' capacities versus markets.

6.1.2.3 The implementation of the Euro

The ECU exchange rates were frozen on 31 December 1998 at market rates establishing the value of the euro (substituting the ECU at par). The euro became the accounting currency of participating countries and was gradually introduced in 2002. Currently, it is the official currency in 16 of 27 EU member states. The eurozone comprises: Austria, Belgium, Cyprus, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia and Spain. The currency is also used in five countries and territories on the basis of a formal agreement and in six other countries that adopted the Euro unilaterally (Nationalbanken 2009).

ERM II replaced the original ERM in 1999. The Greek and Danish currencies were part of the new mechanism. However, Greece joined the euro in 2001. ERM II keeps the band for currency fluctuations against the euro within a range of 15 per cent on either side of parity. Denmark keeps

the exchange rate of the krone within a narrower range of 2 ¼ per cent on either side (Nationalbanken 2009).

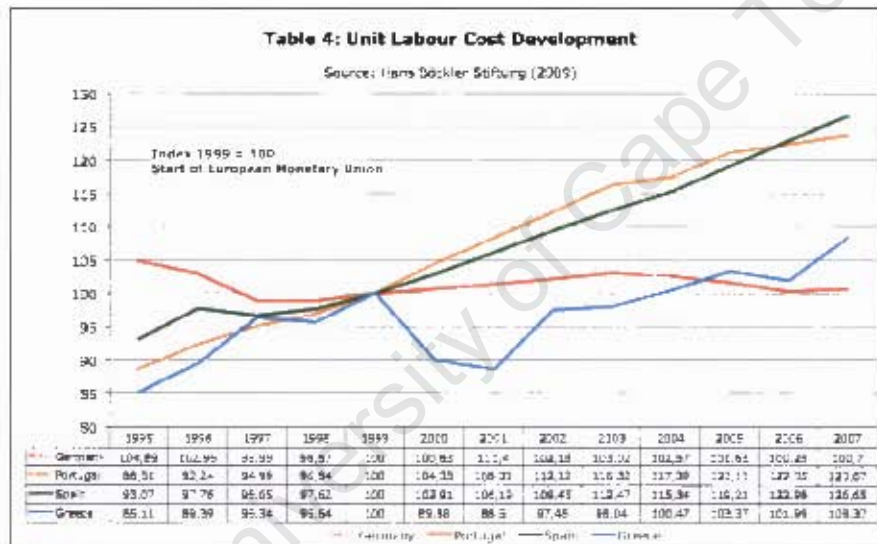
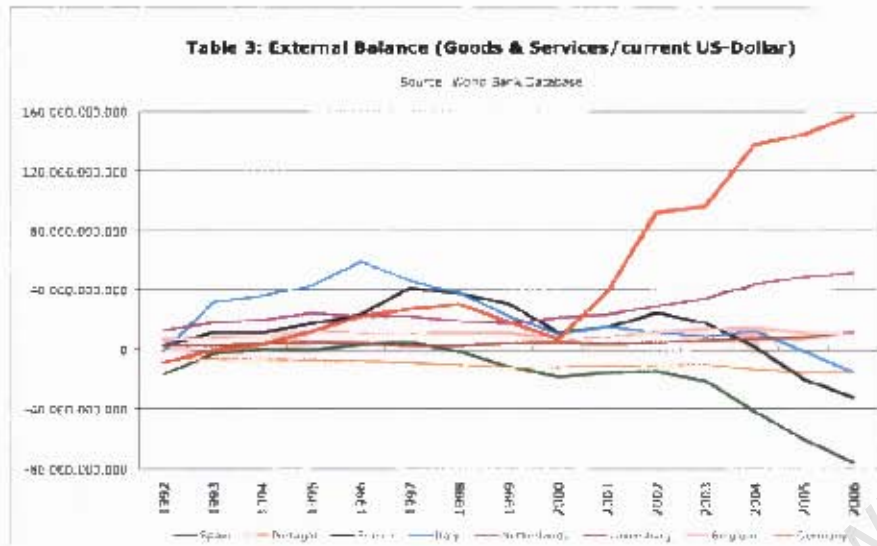
Chapter 6.2 will briefly illustrate current tensions within the eurozone. Chapter 6.3 will propose a relationship between financial power and national attitudes to EMU.

6.2. Conflicts in the eurozone

European monetary unification has intensified the debate about German mercantilism and economic governance in Europe ('Are German Workers Killing Europe' 2006).

Government bond yields in Europe had sufficiently converged and inflation has been reduced significantly by means of monetary and fiscal measures (Goodhardt 2007: 97). However, trade patterns within the EU are highly unbalanced, with Germany being a prominent surplus country, reversing the conversion process⁴⁹. Germany has increased its trade surplus since 1999 significantly while considerably slowing the growth of its domestic economy by further undercutting the inflation rates of its EMU partner countries (see *Table 3 & 4*) (Flassbeck & Spiecker 2005; Herr & Kazandziska 2007: 141).

⁴⁹ The current economic crisis has significantly widened bond yields on government debt again. The lack of bail-out provisions or ECB financing for countries facing state insolvency has fed into existing divergences, provoking speculations over dissolving the monetary union (Münchau 2009).



Since exchange rates have been sacrificed in favour of the euro, the real devaluation of countries such as Germany by wage restraint remains unchallenged. The President of the Deutsche Bundesbank, Axel Weber, has argued that trade deficits are sufficiently compensated by lower domestic interest rate levels, since the (faster growing) deficit countries have higher inflation rates while the ECB sets a unitary interest rate (Weber 2005). However, real interest rates exist in a specific point in time, whereas price divergences accumulate. If price levels converge between

EMU member countries, the advantage of lower real interest rates will cease to exist. However, the competitive gap in pricing goods and services accumulated in previous years will persist (Flassbeck & Spiecker 2005: 707). Further, an adequate interest rate policy becomes impossible if price levels diverge too much as the ECB has to consider the economic situation of the whole union. Therefore, interest rates will be too high in some countries and too low in others.

Unequal trade patterns exist across regions in most currency areas of the world. However, the eurozone differs markedly from a single political entity with central or federal governance based on citizenship and democratic legitimacy (Eichengreen 1993: 1321-1322). Further, economic imbalances across regions can provoke political tensions even within nation states, as witnessed between Western and Eastern Germany or the North and South of Italy.

German mercantilism has provoked high-level political reactions from France and other EMU partner countries ('Merkel's lack of resolve poses risk to Germany' 2008). The perspective of the beggar-thy-neighbour policy for a country with a huge internal market such as Germany remains unclear. Either deficit countries have to be alimented with structural funds, (while growth of the domestic economy in Germany remains low) or the currency union has to dissolve.

The current economic crisis has again underscored the beggar-thy-neighbour approach of the German government. Germany refused to take appropriate fiscal measures and thereby address unequal trade patterns within the EU and versus the US economy. Apparently, Germany speculates on a free ride on fiscal programmes of neighbouring countries (Hutton 2008).

Hence, pressures to strengthen the soft economic coordination in Europe beyond the deflationary implications of the Maastricht Treaty will probably intensify. The Keynesian orientated then Finance Minister of Germany,

Oskar Lafontaine, and his French counterpart, Dominique Strauss-Kahn, initiated the Cologne Process in 1999 (Heise 2008). The Cologne Process aimed at strengthening European economic governance but degraded to a mere consultative mechanism after Lafontaine resigned over disagreements with then German chancellor Gerhard Schröder. However, the French President Nicholas Sarkozy has repeatedly called for European economic governance coordinating monetary, fiscal and wage policies during the current economic crisis (European Parliament 2008).

6.3 European Monetary Union (EMU) and national preferences

The previous chapters on the history of EMU highlighted national approaches to monetary regionalism. The current chapter tests whether financial power coincides with these patterns of monetary integration policies.

Table 4 proposes a monetary hierarchy of EU member countries based on their relative degrees of financial power. A higher positive score indicates more financial power. The corresponding data is given in *Table 5* and *Table 6*.

The comparison ignores latecomers and specific cases of EMU member countries as indicated in the introduction to the thesis. In consequence, eight EMU member countries will be analysed: Belgium, France, Germany, Italy, Luxembourg, the Netherlands, Portugal and Spain. The indicators for measuring financial power are the trade balance, openness to trade, inflation rates and the status of the currency as international reserve currency. Interest rate policy is being ignored as countries with financial power do not necessarily utilise that power. The strength of the social contract is likewise excluded from the quantitative section, since it involves several conceptual problems as discussed in chapter 3.

Relative financial power is measured on a simple ordinal basis. A score of 1 is associated with more than average financial power, a score of 0 with

average financial power and a score of – 1 with less than average financial power with respect to the specific indicator. The indicators are unweighted. It is not possible to determine within the scope of the present dissertation whether one specific indicator (e.g., the status as international reserve currency) bears more importance than the other indicators utilised. Hence, the empirical evidence serves mainly to test the hypothesis developed in the theoretical section. So far, no general empirical concept has been established in relevant literature to measure financial power.

Indicators of financial power

Lower inflation broadens the scope for expansionary monetary policy and is therefore associated with more financial power. Openness to trade (more than the average of EMU countries) is associated with less financial power. Open economies are more vulnerable to exchange rate movements and depend on price stability in order to maintain a positive trade balance. A positive trade balance (with respect to EU non-EMU countries) instead will be associated with more financial power.⁵⁰ A surplus in the trade balance reflects lower relative prices in comparison with trade partners and a creditor position in the balance of payments, and raises demand for the domestic currency as a medium of transaction (status as international reserve currency). These factors broaden the scope of monetary policy as discussed in chapter 3. The status as international reserve currency reflects and supports investors' willingness to utilise a currency in international transactions and as a store of value, hence relaxing external constraints on monetary policy. The status of a currency before the introduction of the common currency will be defined according

⁵⁰ It should be noted that trade patterns also depend on specialisation, the overall structure of the economy and its geographical location. Further, some countries might run a trade surplus with EU members but a trade deficit with the rest of the world and vice versa. However, since EU member countries operate within a common market and peg their currencies against the eurozone, the data is a fairly good indicator of relative financial power.

to the international reserve currency composition (IMF 2008). However, only three European currencies could be considered as relevant international reserve currencies: The Deutsche mark, the French franc and the Dutch guilder.

Table 5: Monetary Hierarchy

Country Rank	Inflation	Internal Market	Intra-European Trade Pattern	International Reserve Currency Status prior to EMU	Total Score
1.Germany	1	1	1	1	4
2.France	1	1	-1	0	1
2.Netherlands	1	-1	1	0	1
3.Belgium	1	-1	1	-1	0
3.Italy	-1	1	1	-1	0
4.Luxembourg	1	-1	-1	-1	-2
4.Portugal	-1	1	-1	-1	-2
4.Spain	-1	1	-1	-1	-2

See⁵¹ for Explanation of Table 5

Table 6 and Table 7 present the aggregated data utilised in Table 5. Table 5 provides the average inflation rates and the average quota of trade to GDP within the concerned period. Table 7 provides each concerned country's trade balance with the rest of the EU over the given period.⁵²

⁵¹ *Inflation*: 1 = lower than average of countries; -1 = higher than average of countries; *Internal Market*: 1 = trade to GDP lower than average of countries; -1 = trade to GDP higher than average of countries; *Intra-European Trade Pattern*: 1 = positive trade balance with the rest of EU in majority of years; -1 = negative trade balance with the rest of EU in majority of years; *Status as International Reserve Currency*: 1 = important international reserve currency of IMF; 0 = moderate importance as international reserve currency of IMF; -1 = no importance as international reserve currency of IMF

⁵² The data in Table 6 is limited to the period since 1992. Only since then has common statistical data been available for reunified Germany. The data in Table 7 is limited to the period since 1999, when national currencies were abolished and could no longer distort intra-European trade patterns

Table 6: Inflation and Trade Openness (approximated averages for period 1992-2006)⁵³

Source: World Bank Database; own calculations

Country	Inflation	Trade to GDP
Netherlands	2.05 %	111.52 %
Luxembourg	2.11 %	241.47 %
Belgium	1,99 %	149,17 %
Germany	2,00 %	60,25 %
Spain	3,51 %	49,02 %
Portugal	3,76 %	64, 55 %
France	1,68 %	49,21 %
Italy	3,02 %	47,72 %
All Countries	2,52 %	96, 16 %

⁵³ Germany's average inflation is overstated, since unification led to an exceptional inflationary episode.

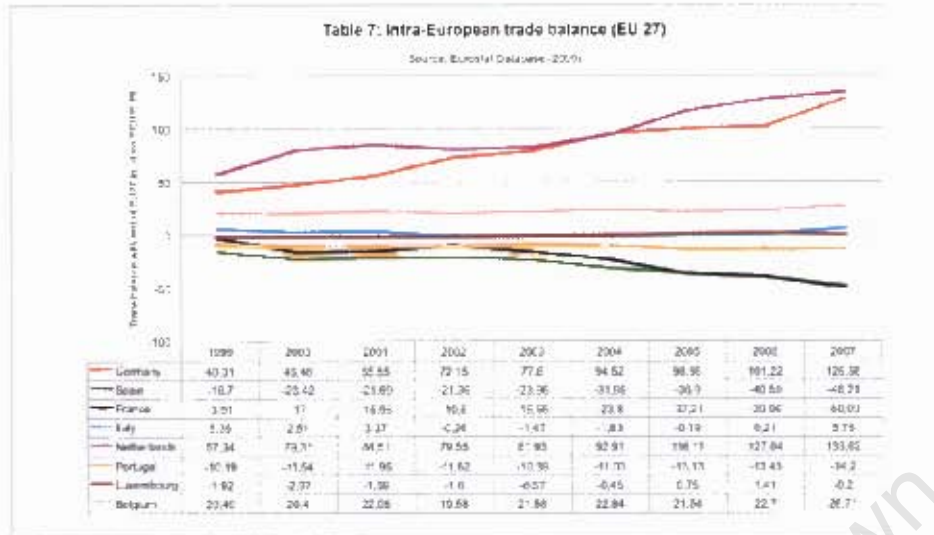


Table 5 confirms the broad assumptions on national monetary integration policies stipulated in chapter 2.3. However, they have to be explained in conjunction with broader political goals. Monetary hierarchies do clearly exist even within regional country groupings. Further, countries from an intra-European region with more financial power may possess less financial power than a stronger country from a region with overall weak financial power. Consequently, the initial research hypothesis and the proposed patterns of national integration policies have to be further differentiated with respect to the previous case study and the monetary hierarchy developed in Table 5:

Germany is a clear-cut case of a country with pronounced financial power and only gradually recovering political sovereignty. Ever since Germany shifted towards being a surplus country and established itself as monetary leader in Europe with a strong domestic social contract, it featured a rather unilateral approach to monetary integration. Although Germany welcomed closer political integration in the domain of foreign policy, it was reluctant to accede to monetary integration. Germany only gradually gave up opposition to EMU. The German reunification and thus its consolidation of political sovereignty, as well as the French policy shift after the Keynesian period under Françoise Mitterrand were crucial to German elites pursuing

EMU. Hence, trade integration and broader political goals clearly played a decisive role in Germany favouring monetary integration.

France possessed greater regional autonomy over its foreign policy but less financial power than Germany. It featured a rather multilateral approach to monetary integration, at the same time trying to limit the role of parliamentary control over intergovernmental bargains. France's rather closed economy reaffirms its policy stance. When French policy-makers sought to assume a lead currency role for the franc in the aftermath of Germany's inflationary episode (reunification), they continued lowering interest rates. Hence, a potential French financial leadership would have been entirely different from Germany, which pursued a rather restrictive monetary policy despite its well-positioned currency. The French approach perfectly fits the French attitude towards the lead currency role of the US dollar during the Bretton Woods era and France's relatively closed economy (see *Table 6*). Hence, trade integration played a minor role for France in pursuing EMU while increased financial power explains its motives best.

The *Benelux countries* differed according to their monetary status. They pursued a rather federalist approach to political integration compensating for their relative weaker bargaining power in comparison with the regional hegemons Germany and France. Belgium and even more so Luxembourg possess little financial power. Hence, these two countries followed a multilateral approach to monetary integration. The Netherlands, while also lobbying for a multilateral political design of the European project, followed the German lead in monetary affairs. The country had shifted towards highly centralised wage bargaining after an inflationary bubble in the 1970s and huge unemployment rates. It thereby successfully moderated wage increase below the German level, reflecting lower productivity and strong trade ties with Germany (Bofinger & Flassbeck 2000: 24; Noordman 1995). Hence, the Netherlands possessed more financial power than their Benelux counterparts. In sum, the benefits of trade integration clearly played a role in determining the Benelux countries' pursuit of EMU while

the monetary approach differed according to their respective financial power.

The *Southern-Mediterranean countries* have been less exposed in the previous analysis as only Italy joined the EC early enough to have a meaningful influence on monetary regionalism. These countries possessed smaller financial power. Italy plays an exceptional role. It possesses little overall financial power (comparable to Belgium) but more than Luxembourg, Spain or Portugal. Italy pursued a flexible approach, trying to bargain a better deal with respect to structural funds while fully endorsing closer monetary integration. Spain and Portugal joined the EC after the regional funds had been designed and monetary integration had been pursued for some time. They followed a multilateral approach to monetary integration. However, their economic preferences clearly differ too markedly from those of Germany to have followed its lead in monetary affairs (Royo 2006; Venegas 1997; Beggarthy neighbour 2008). Gaining financial power via a common currency must have outweighed the disadvantages of sacrificing competitive devaluation as a buffer against trade penetration. That hypothesis is confirmed by the low level of real interest rates in Spain feeding an enormous construction and real estate sector boom while aggravating trade deficits (Herr & Kazandziska 2007:).

The *UK* and the *Nordic countries* (except Finland) abstained from EMU. Again, this must be explained with (domestic) politics (widely neglected throughout this dissertation) and with respect to financial power. The Anglo-Saxon and the Scandinavian economic model differ markedly from each other and from the political economy of Continental Europe. Both regions were less affected by the devastations of WW II and had a strong tradition of regional autonomy. They soon displayed trade deficits due to higher price level as compared to the catching-up economies. The UK speculated on consolidating the role of sterling as the second most important reserve currency after WW II by heavily liberalising financial markets. Further, the UK's experience with regard to monetary solidarity in Europe was rather fatal. The Nordic countries applied capital controls prior

to the adoption of the Maastricht Treaty to safeguard their financial power. However, EU membership has put the Scandinavian approach to economic and welfare policies under pressure (Rojas 2005: 60-65). Sweden deliberately refused to join the euro by not abiding by the fiscal rules of the Maastricht Treaty and pursuing a rather interventionist policy (European Union 2009). The average growth performance of Britain and the respective Scandinavian countries compared to the EMU have so far justified their approach (Strassel 2009: 4). However, the current economic crisis and the gradual loss of sterling's status as international reserve currency have intensified the debate about Britain adopting the euro (Moore 2008).

In sum, the concept of financial power coincides well with the national approaches to EMU. Countries with more financial power pursued monetary regionalism in order to defend existing trade patterns, whereas countries with little financial power tried to substitute limited national monetary sovereignty with increased regional monetary sovereignty.

Financial power may not be isolated from the political agenda of national governments. An eclectic approach considering broader political goals is crucial to understanding national attitudes towards monetary regionalism. Certainly, national attitudes also depend on the ideological roots of political decision-makers. However, the German and French cases are telling: In 1999, then German Finance Minister Oskar Lafontaine could not force through monetary multilateralism against the reservations of important domestic agents such as the Deutsche Bundesbank (see chapter 6.2). Conversely, France has lobbied for monetary regionalism even under conservative governments. Therefore, it is sensible to assume that the unequal distribution of financial power heavily conditions political approaches of national governments.

7. Conclusion

Economic theories of regionalism have commonly neglected political factors such as cooperation in the security structure determining and enabling deeper regionalism. The dissertation has explained European integration within a framework of eclectic state-centric realism, assuming that nation states continue to define the character of regional integration. European integration has been a hegemonic project under unique historical circumstances: The US sponsored European regionalism in order to keep Western Europe in its sphere of influence during the Cold War. However, the cooperation of two Continental European hegemons, France and Germany, has been the driving force of deeper European integration. The military and economic setbacks to these countries from two World Wars have paved the way for closer integration. National bargains have conditioned the character of early European regionalism. Firmly grounded national attitudes continue to influence new regionalism and hence monetary integration.

Financial power is defined as the potential to stimulate economic development through the provision of sufficient credit. It is conditioned by the domestic social contract (centralised wage bargaining) and the monetary or exchange rate regime. Relevant indicators of financial power are the status of a currency as international reserve medium, low inflation and hence a positive trade balance (with the exception of countries assuming a role as lender of last resort), as well as a huge internal market insulated from trade penetration. Financial power is unevenly distributed among nation states and their respective means of exchange. Hence, the dominant economic theories stipulating an equal distribution of financial power are rejected. The unholy trinity of monetary sovereignty, stable exchange rates, and openness to capital flows must be restated as unholy duality (unholy *duality* of capital liberalisation and monetary sovereignty). Nation states with little financial power trying to preserve or increase financial power will either have to restrict capital flows or opt for monetary regionalism.

The financial system of Bretton Woods has never been fully symmetric in design. Nevertheless, the dollar-gold standard of the Bretton Woods era has contributed to a more equitable distribution of financial power based on selective capital controls. However, the gradual relaxation of capital controls and the military undertakings of the United States in Korea and Vietnam have deepened the contradiction of financial leadership. The US dollar was caught between providing international liquidity and defending the gold parity. The Bretton Woods System collapsed when the US was no longer willing to subordinate domestic political concerns under global monetary stability. The abolition of the Bretton Woods financial system and the depreciation of the US dollar have spurred European monetary integration since nation states were under threat of declining financial power.

However, the conflict between the monetary agenda of the regional financial leader Germany and countries with less financial power (economists versus monetarists) such as France has produced severe setbacks to European monetary integration. Monetary regionalism has been a tool for the rival agendas of increasing financial power and preserving unequal trade patterns.

Germany had pronounced financial power. It therefore pursued an agenda rather hostile to symmetric monetary regionalism. Germany's approach to monetary integration had been conditioned by its desire to preserve unequal trade patterns. However, the country made concessions with respect to closer political integration. France has lobbied for a rather multilateral design of monetary integration based on its lesser financial power and the importance of its internal market. While the country has been sceptical of federalist governance (limiting the scope for intergovernmental and hegemonic bargains) it lobbied for intergovernmental economic governance (hedging Germany's mercantilist agenda). The Benelux countries have usually sponsored (monetary) regionalism based on their small financial power, high openness to trade and limited political sovereignty. However, the Netherlands with slightly

more financial power has followed the German lead in monetary affairs. The Southern Mediterranean countries have opted for closer political and monetary integration due to little financial and trading power. Italy has played an exceptional role, temporarily following the German lead in monetary affairs in order to bargain structural funds. The UK and the Nordic countries (except Finland) have developed a rather unilateral response to globalisation. They abstained from monetary union for domestic and historical reasons, since they had been less affected by World War II and therefore were less dependent upon political integration. Further, their abstention indicates that their political and economic systems (Anglo-Saxon and Scandinavian capitalism) at the margins of the European political landscape could not be as easily reconciled with the Rhenish capitalism dominating Continental Europe.

The dominant concepts of monetary regionalism have changed over time. The conceptual shift from positive to negative integration reflects the evolution of relative power and intergovernmental bargains in Europe. The pressures for increased trade integration after the global monetarist recession of the post-Bretton Woods era and the end of the Cold War have transformed the character of European monetary regionalism in favour of Germany. An important turning point was the inability of the French government to pursue Keynesian economic policies in a non-cooperative monetary environment against Germany. The Single European Act and the decision to liberalise capital flows have further increased pressures for monetary integration in order to contain political opposition to European economic integration. Germany's reunification and its consequent rise in political sovereignty have led its political elites to accede to a definitive monetary union. Hence, the dispute over regionalism being a response or a part of globalisation may be reconciled.

The initial research question asked *why EU members sacrificed their national monetary policies in favour of a common currency (euro) against the background of financial globalisation.*

The dissertation established that for countries with little financial power monetary regionalism is a response to globalisation while Germany with huge financial power has pursued monetary union to preserve its trade patterns with EU member countries and consolidate its political sovereignty.

The current monetary union is at risk, since the German mercantilist agenda has pronounced unequal trade patterns. In the long run, Germany will have either to provide structural funds for countries with little financial power, or economic integration has to be further developed towards a truly European economic governance establishing mechanisms to reduce internal divergence within the currency area. Otherwise, the monetary union might dissolve.

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Appendix

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I. Purchasing Power Parity (PPP)

Absolute PPP states that market forces equalise purchasing power of different currencies for a basket of homogenous and tradable goods (assuming perfect information, no transportation costs, perfect competition, similar baskets of commodities, absence of barriers to trade and unrestricted capital flows). *Relative PPP* states that nominal exchange rate movements will adjust for differences in the real exchange rate (the purchasing power of a basket of goods in terms of another region's basket of goods) (Krugman & Obstfeld 2003: 389-394).

*Example*⁵⁴: A pair of identical and tradable shoes costs \$20 in the US but only €10 in an EMU country. Then one US dollar (\$) must buy half a euro (€) or one € buys two \$ in order to equalise the price for a pair of shoes. If the exchange rate or the shoe price does not meet these criteria, arbitrage will occur. If one \$ buys one € in that example, "hungry arbitrageurs" will buy shoes in Europe. They will thus increase the price of shoes in Europe and/or the demand for € (appreciation of € versus \$) until purchasing power has equalised (one € buys two \$).

Absolute PPP can be expressed as:

$$E_{\$/\epsilon} = P_{US}/P_E$$

E denotes the exchange rate; P denotes the price level

Relative PPP can be expressed as:

$$(E_{\$/\epsilon, t} - E_{\$/\epsilon, t-1})/E_{\$/\epsilon, t-1} = \pi_{US, t} - \pi_{E, t}$$

, and t-1 denote a time frame in which a change occurs;

π denotes the rate of inflation

(Krugman & Obstfeld 2003: 390-391)

⁵⁴ For simplification the example operates with a specific commodity instead a basket of goods.

II. Uncovered⁵⁵ Interest Parity (UIP)

UIP operates similarly (assuming perfect information, identical risk premium and openness to capital flows): It maintains that currency markets equilibrate when the *expected returns* on different currencies equalise (which eliminates incentives for arbitrage). The return on a currency is given by the nominal interest rate and the expected change in the exchange rate (Krugman & Obstfeld 2003: 341-346).

Example: \$1 buys €1 but the nominal interest rate level is higher in the US than in the EMU area. According to IRP this can only be justified, if the interest rate differential equals the expected change in the exchange rate (the US-\$ is expected to depreciate). From a standpoint of intuition one might expect that shifting funds into \$ might be more attractive. However, according to the model, rational investors expect a certain future exchange rate which will eliminate incentives for arbitrage. Hence, if investors were to shift their funds into \$, raising its value in relation to the € in the short-term, the \$ is expected to depreciate even more in the future (E is expected to rise, see below).

The relationship can be expressed as

$$R_{\$} = R_{\text{€}} + (E^{\text{e}}_{\$/\text{€}} - E_{\$/\text{€}}) / E_{\$/\text{€}}$$

R denotes the interest rate on a deposit; E^{e} denotes the expected change in the exchange rate

(Krugman & Obstfeld 2003: 342)

⁵⁵ Covered interest rate parity involving forward exchange rates (defined via contract) instead of future expected exchange rates is neglected.

III. Balassa-Samuelson-Effect

The baskets of commodities of two national economies consist of 50 per cent tradable and non-tradable goods and services (which is a good approximation for very small open economies).

Example: The domestic economy grows by 4 per cent. The productivity in the tradable sector rises by 8 per cent while productivity does not rise in the non-tradable sector. Hence, the average increase in productivity for the whole economy is 4 per cent. If according to the law of one price or mobility of workers wages rise by 8 per cent in both sectors, the overall price level will rise by 4 per cent.

In the foreign economy the productivity increases by 4 per cent in the tradable sector and does not rise at all in the non-tradable sector. Again, an increase in wages by 4 per cent will increase the overall price level by 2 per cent.

According to PPP, the currency of the domestic economy must depreciate by 2 per cent in the previous example to offset the changes in the price level. However, the competitive situation between the economies' tradable sectors remained exactly the same as wages in that sector reflect the increase in productivity.

We can reconsider the example by assuming that wages did follow average productivity. In this case the prices of tradables could be lowered by 4 per cent in the domestic economy and by only 2 per cent in the foreign economy. Now the domestic economy certainly enjoys an advantage. However, if the exchange rate eliminates this advantage, it also eliminates the incentive for innovation within and across economies. The nominal exchange rate works like a tax on extra profits accumulated by the most productive entrepreneurs (Flassbeck 2000: 13).

IV. Currency Board

The exchange rate between the domestic currency and the foreign anchor currency is fixed.

Every market participant has the right to exchange domestic currency of any quantity and at any time into the anchor currency.

The anchor currency must be held at a sufficient level (usually up to 110 per cent of the domestic monetary base).

A currency board requires a strong political consensus (sometimes even a constitutional clause) about the system in order to guarantee its credibility.

A currency board has no powers to effect monetary policy and does not lend to the government.

A currency board does not act as a lender of last resort to commercial banks, and does not regulate reserve requirements.

A currency board does not manipulate interest rates via a repo rate like a central bank. The peg with the foreign currency keeps interest rates and inflation closely aligned to those in the country against whose currency the peg is fixed.

(Hanke 2002: 203-222)

V. Bimetallism

Bimetallism created incentives for arbitrage:

Example: If the mint stood at 15 ½ to 1 (as in France in 1803), the mint supplied coins of equal value containing a certain amount of gold or 15 ½ times as much silver. When the mint ratio rose to 16, traders could import 15 ½ ounces of silver and receive one ounce of gold. One ounce of gold sold for 16 ounces of silver on the world markets, thereby securing the arbitrageur an extra half ounce of silver (Eichengreen 1996: 10-11). This process drove silver in and gold out of the market (and vice versa).

VI. The Keynes Plan for an International Currency Union

John Maynard Keynes lobbied for international money. He envisaged an accounting currency (bancor) administered by an International Clearing Union (ICU), against which credit and liabilities would be held. National central banks would keep accounts with the ICU "through which they would be entitled to settle their exchange balance with one another at their par value as defined in bancor" (Horsefield 1969: 3). Countries would not hold liabilities against each other but against the currency union as a whole. Keynes, who had warned that the burden of German reparations after World War I would have negative repercussions on other European economies, saw bilateral liabilities as a source of political conflict and war (Keynes 1929: 1-7). Hence, deposits at the ICU would be used to lend money to deficit countries, circumventing deflation as an adjustment mechanism. The penalties or quotas applied to excessive creditor and debtor countries and provisions for trade sanctions or currency realignments should have ensured a multilateral approach to balance of payment adjustment. In sum, Keynes did not want to sacrifice the domestic interest rate policy for ensuring external balance (Muchlinski 2005: 64; 67).

VII. The disintegration of the gold standard

Gold had mostly vanished from circulation during World War I, since governments had concentrated it in their central banks' vaults. In order to stretch the scarce supply of gold which limited monetary expansion, foreign exchange had been included in central banks' reserves as a gold substitute. If all countries had agreed to hold a portion of foreign exchange in their portfolios, they would have relaxed the limitations of gold on the money supply. However, in the absence of collective coordination, countries that relaxed the gold constraint could fall prey to speculators. British interests to halt a further decline in prices (which complicated restoring sterling's pre-war parity) and the role of the City as international harbour for foreign exchange facilitated an international agreement. However, the US had enjoyed a considerable rise in its gold reserves and opposed such plans (Eichengreen 1996: 61).

The Great Depression first reached the periphery and then spread to the industrial core. Austria and Germany experienced huge banking crises that in turn infected Britain. Britain's financial system had looser ties to the industrial sector than was the case in Continental Europe, but the credit crunch spread through the banking system. Mercantilist responses to the crisis further hurt British income from interest, foreign investment, shipping and insurance⁵⁶. As a result three dominant blocks emerged: A gold-standard block led by the United States, the sterling area where many British trading partners pegged to the sterling, and the Central and Eastern European countries, led by Germany, which imposed exchange controls (Eichengreen 1996: 49; 81).

⁵⁶ The popular British scepticism towards European monetary integration has its historical roots in the events of that time. British merchant banks had considerable claims against central European banks. The largest Austrian Bank (Wiener Kreditanstalt) collapsed and caused a run on the deposits in central Europe. Central European governments then confiscated British assets (James 1996: 22).

VIII. Special Drawing Rights (SDRs)

SDRs entitle the respective country unconditionally to obtain a certain amount of widely accepted currencies (in proportion to its IMF quota). Currently, SDRs are composed of US dollars, the euro, pound sterling and the Japanese yen. Before the introduction of the euro SDRs included the French franc and the German Deutsche mark. However, SDRs became meaningless under freely floating exchange rates (International Monetary Fund 2009).

Some major industrial countries were increasingly concerned about a possible shortage of liquidity to finance their payment balances if the US deficit should ever disappear (BMF 1977: 22). The volume of global trade had risen significantly compared to the level when the Bretton Woods agreement had been concluded. This motivated the Group of Ten (G 10) to increase quotas and allocate resources to a small number of industrial economies responsible to extend credit on conditional terms.

However, developing countries objected to the exclusive approach stressing their greater financing needs (Eichengreen 1996: 118). The controversy was even harder to solve among industrial countries with different degrees of financial power. Weak currency countries favoured additional finance and provoked opposition from strong currency countries such as Germany (BMF 1977: 26; Eichengreen 1996: 119). In 1965 the US reversed its stance and agreed to create SDRs. The London-based market premium on gold indicated that the financial position of the dollar was not sacrosanct and France otherwise threatened to liquidate its dollar reserves. However, France had been successful lobbying for a provision that SDRs would only be enacted if the adjustment mechanism had been improved (meaning the "privileged" US deficit had vanished) (Eichengreen 1996: 119).

IX. The real asymmetry of the European Monetary System (EMS)

Example: If the French franc came under attack and reached its intervention point, the Banque de France (BDF) either had to use its own reserves to buy the franc by supplying Deutsche marks to the market or to utilise the credit lines from the VSTF. The credit facility of the ERM was unlimited in the short-term. However, subsequently the credit had to be repaid by the central bank in assets other than its own currency, imposing a budget constraint on France. Consequently, the BDF could either raise interest rates to follow the restrictive monetary policy of its counterpart or it had to devalue the franc. The effects on the monetary policy of Germany on the other hand have to be divided into the implications for its reserves and the liquidity of its domestic banking system: The Bundesbank simultaneously had to buy French assets and supply Deutsche marks to the market. It immediately transferred them to the BDF where they were denominated in ECU. However, the French VSTF account was debited and Germany was accordingly credited, again requiring France to adjust its policy to avoid insolvency. However, the liquidity effect on Germany's domestic banking system could be easily neutralised by the Bundesbank.

(Bofinger & Flassbeck 2000: 7)

X. List of abbreviations and acronyms

BDF

Banque de France

Benelux

Group of Western European states comprising Belgium, Netherlands and Luxemburg

BMF

Bundesministerium der Finanzen (German Ministry of Finance)

BOE

Bank of England

CEEC

Committee for European Economic Cooperation

COMECON

Council for Mutual Economic Assistance

ECA

Economic Cooperation Administration

ECB

European Central Bank

ECE

Economic Commission for Europe

EEC

European Economic Community

Financial Power & Monetary Regionalism

EC

European Community

ECSC

European Coal and Steel Community (Montan Union)

ECU

European Currency Unit

EFTA

European Free Trade Area

EMA

European Monetary Agreement

EMCF

European Monetary Cooperation Fund

EMI

European Monetary Institute

EMS

European Monetary System

EMU

European Monetary Union

EPC

European Political Community

ERM

European Exchange Rate Mechanism

EPU

European Payment Union

EU

European Union

EURATOM

European Atomic Energy Community

FDI

Foreign Direct Investment

FED

Federal Reserve Bank

FTA

Free Trade Area

GATT

General Agreement on Tariffs and Trade

GDP

Gross Domestic Product

GDR

German Democratic Republic

ICU

International Clearing Union

IMF

International Monetary Fund

Financial Power & Monetary Regionalism

ITO

International Trade Organisation

NAFTA

North American Free Trade Agreement

NATO

North Atlantic Treaty Organisation

OECD

Organisation for Economic Cooperation and Development

OEEC

Organisation for European Economic Cooperation

OCA

Optimum Currency Area

OMO

Open Market Operation

OPEC

Organisation of Petroleum Exporting Countries

PPP

Purchasing Power Parity

SEA

Single European Act

SDR

Special Drawing Right

TEC

Treaty establishing a European Constitution

UIP

Uncovered Interest Parity

UK

United Kingdom

UN

United Nations

UNCTAD

United Nations Conference on Trade and Development

US

United States of America

USSR

Union of Soviet Socialist Republics

VSTF

Very Short Term Financing Facility

WW

World War

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