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The euro: economic rationality or political construct?

After World War II, gradually deepening integration achieved a notable success in Europe. During the decades between 1950 and 1990, often described as the 20th century 'golden age' for Europe, GDP per capita in the major economies of Western Europe increased to 3-4 times its value, approaching 70 per cent of economic development in the US by the early 1990s. Moreover, the fall of the Berlin Wall and the Iron Curtain provided an unprecedented opportunity to further deepen integration and thereby to reposition Europe geopolitically.

Ecstatic from the progress made, the European political elite identified creating a currency union as the next stage of evolution. However, decision makers were sharply divided over the idea. One cautious view, adopted mostly by central bankers, was that monetary union should be agreed as one of the final stages towards economic and political integration. This is also demonstrated by Alexandre Lamfalussy's recollection that 'there never would have been a single currency if the decisions had been left to the central banks'.[1] Under the more optimistic approach, creating monetary union could by itself foster as a catalyst the creation of economic and political union as the ultimate goal.

Countries joining the monetary union were far from meeting the criteria for an optimal currency area. There were significant differences across the countries signing the Maastricht Treaty in 1992 in the areas of inflation, the government debt, the fiscal budget, the current account position, productivity or the structural characteristics of the labour market. These differences widened further with Member States joining at a later time. This is particularly problematic in cases where even the development of the entry criteria, intended to guarantee successful membership, is overshadowed by disputes between politicians and economists. The Maastricht criteria fell victim exactly to this. Right at the inception, at least one-quarter of the countries failed to meet the five criteria set and approved by the twelve Members States.

In open economies, the existing structural differences can appear in exchange rate deviations from time to time. In the case of the euro area, the importance of this was well illustrated by the fact that, for over a period of more than a decade after 1979 within the European Monetary System (EMS), the participating countries adjusted the parity on a total of 62 occasions. The extent of this could sometimes be as high as 10 per cent. By introducing the single currency, the Member States immediately abandoned the familiar use of autonomous interest rate and exchange rate policies.

Nobel Laureate US economist Milton Friedman highlighted the risks back in 1997, indicating that no good will come out of currency union if adequate alternative adjustment mechanisms are not available to replace the exchange rate.

[1] LAMFALUSSY, C. – MAES, I. – PETERS, S. (2014): Alexandre Lamfalussy. The Wise Man of the Euro. Mathias Corvinus Collegium, Budapest.

In opposition to the sceptics putting forward economic arguments, political bargaining and the federalist approach ultimately gained the upper hand. The bottom line is that creating the single currency was, in the words of Alexandre Lamfalussy, a 'political mechanism'. Common belief replaced a deliberate construction process leading to European integration. Namely, the belief that the single currency, introduced prematurely compared to the degree of integration achieved, will be able to resolve the existing structural differences between Member States and remedy institutional weaknesses. However, our economies are shaped by inexorable rules, where desires rarely find fulfilment in the absence of proper foundations. The rest is history.