



Euro Symposium

The Euro and the German Veto

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ABSTRACT

Why They Thought It Couldn't Happen

American (and European!) economists did not understand the politics behind EMU at the time. The political causes of EMU were revealed by Jacques Attali, adviser to French president Francois Mitterrand, as late as 1998. In a television interview he said (my translation),

It is thanks to French reticence with regard to an unconditional reunification [of Germany] that we have got the common currency....The common currency would not have been created without the reticence of Francois Mitterrand regarding German unification.²

In 1999, this interpretation was confirmed by Hubert Védrine, another longtime foreign policy adviser to Mitterrand and later his minister for foreign affairs:

The President knew to grasp the opportunity, at the end of 1989, to obtain a commitment from [German Chancellor Helmut] Kohl....Six

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2. The interview is shown in the film "The History of the Euro." The German version was broadcast on March 26, 1998. All interviews were presented in the original with German subtitles. Attali (1995, 353-358) had hinted at this linkage already in his memoirs.

months later, it would have been too late: no French President would have been in a position any longer to obtain from a German Chancellor the commitment to introduce the common currency. (Quatremer and Klau 1999, 172, my translation)

On the German side, there is a single sentence in the memoirs of Horst Teltschik, chief foreign policy adviser in the Chancellor's office, confirming Attali's testimony. Teltschik (1991, 61) quotes himself telling a French journalist at the beginning of December 1989 (i.e., three weeks after the fall of the Berlin Wall and ten days prior to the Strasbourg summit calling the intergovernmental conference on EMU) that "the German Federal Government was now in a position that it had to accept practically any French initiative for Europe." In a 1998 interview, Richard von Weizsäcker, President of Germany, called EMU the price of German reunification, but Kohl always denied this, and Hans-Dietrich Genscher, the minister of foreign affairs from 1974 to 1992, called it a "legend."³ My historical research on these events has been published in Vaubel (2002), which cites many more sources.

Jonung and Drea (2010) quote Barry Eichengreen (1996) predicting that EMU "will happen if there exists a viable package in which the French get EMU and the Germans get an increased foreign policy role in the context of an EU foreign policy." This had been Genscher's (and probably Kohl's) original strategy, but it was overtaken by events—the prospect of German reunification. Genscher's original strategy had been aptly described by Bernard Conolly (1995, 73f.):

Genscher...wanted to change the perception of Germany as an economic giant but a political pygmy....Political union...would provide a convenient shell for German diplomatic action....Genscher was prepared to offer France the bait of a diminution of German national sovereignty in monetary policy, an area that did not interest him a great deal, in order to increase Germany's diplomatic weight.

Wolfgang Schäuble, state secretary in the Chancellor's office, was even reported to have envisaged a "nuclear option" in which Germany would participate in the framework of a European defense policy. However, in private correspondence, Teltschik wrote me that this had not been Kohl's position. When proposing EMU in February 1988, Genscher was directly reacting to the rejection of European political and military union by the French and the British

3. Von Weizsäcker's interview is in Joergens (1998). Genscher made his claim in a speech in the Bundestag on April 23, 1998 (*Frankfurter Allgemeine Zeitung*, April 24, 1998).

governments at a conference in The Hague in October 1987. In the intergovernmental conference that prepared the Maastricht Treaty, Kohl and Genscher still fought for “European Political Union,” but without success. Their bargaining chip—giving up the German mark—was no longer available for this purpose. It had to be used to obtain Mitterand’s assent to German unification. In the words of Dorothee Heisenberg (1999, 1985), a political scientist,

EMU had been the leverage to achieve greater EU political union. Thus, if anything was traded for German unity, it was Germany’s requirement of significant EU political union....With the timetable for EMU being hurried by Mitterand, the casualty was political union.

Major steps toward a common foreign and defense policy have subsequently been taken in the treaties of Amsterdam, Nice and Lisbon, but these were quite different bargains. Genscher’s proposal of EMU led to the establishment of the Delors Committee, which Jonung and Drea mention in their paper. However, contrary to their claim, it is not true that “the Delors Report of 1989 recommended Economic and Monetary Union.” The Delors Report did not state whether EMU ought to be undertaken or not, otherwise Bundesbank chairman Karl-Otto Pöhl and Bank of England governor Robin Leigh-Pemberton would not have signed it. The report merely stated how EMU would best be attained if the member states decided to strive for it.

Jonung and Drea attribute the crisis of the European Monetary System in 1992 and 1993 to the Danish referendum of June 1992. This is not convincing. The crisis was a consequence of the Maastricht Treaty and German unification. German unification led to massive budget deficits. To counter their highly expansionary effect, the Bundesbank adopted an increasingly restrictive monetary policy. Moreover, the Maastricht Treaty defined convergence criteria for EMU membership, notably an inflation criterion. As I pointed out in January 1993 (Vaubel 1993, 108),

it has strengthened the Bundesbank’s determination to reduce German inflation to very low levels (and to keep it there as long as possible)...As the Bundesbank is not keen to lose its independence to a European central bank, it will make it as difficult as possible for the others to satisfy the convergence criteria with respect to inflation and exchange rate stability.

The markets did not believe that the other central banks would be able to follow. This is why, for all practical purposes, the European Monetary System

collapsed in August 1993. The margins of plus or minus 15 percent established then left the currencies effectively floating.

This leads me to another circumstance that was not expected by U.S. economists—the fact that EMU started with as many as eleven member states. They simply did not imagine that the convergence criteria would be fudged in the way they were. Austria, Germany, Italy and Spain unambiguously violated the deficit criterion. Finland, Ireland, Italy and Portugal unambiguously violated the exchange rate criterion because, at the time the selection was made, they had not been members of the exchange rate mechanism of the European Monetary System for at least two years. Only one member state, Luxembourg, satisfied all convergence criteria unambiguously. In the case of Belgium and the Netherlands, the answer to whether they met all the criteria depended on whether the reduction of the debt-to-GDP ratio—even though still exceeding 60 percent—was considered to be acceptable (Vaubel 1998). Greece, as is now well known, gained admission in 2001 by forging its accounts.

Why did EMU not start with a smaller group of countries? Here is the prediction I made (Vaubel 1993, 111):

How many member-countries will enter the third stage from the beginning? It is safe to assume that no member-government will vote in favour of moving to the third stage unless its own country is admitted to the third stage. Thus, a qualified majority of the Council will decide that a qualified majority of the member-countries is fit to enter the third stage. This implies that European monetary union will not begin with a hard core of hard currencies.

Why They Thought It Was a Bad Idea

Did U.S. economists fail to understand that EMU would feed back to the criteria of optimum currency areas as Jonung and Drea seem to think? I doubt it. This was not a new insight. I quote from a 1976 paper:

Currency unification itself may affect the need for real exchange-rate adjustment....Who knows the size of the impact which currency unification will have on factor mobility, diversification and openness? What is certain is only that it will increase them. Moreover, just because it increases factor mobility, diversification and openness, currency unification has also effects which reduce the need for real exchange-rate adjustment. Indeed, it seems likely that the self-validating forces of

currency unification will prove stronger than the disequilibrating demonstration effect so that observed real exchange-rate changes between independent currency areas will under- rather than overstate the desirability of currency unification. (Vaubel 1976, 441)

However, the argument does not relate to business cycle correlations. Jonung and Drea approvingly report the view of Jeffrey Frankel and Andrew Rose that, as currency unification raises the correlation between national business cycles, it brings the group closer to fulfilling optimum currency area criteria. This is not true. A high positive correlation of business cycles is highly unfavourable for a currency union if it is caused by demand shocks in one country and supply shocks in the other. If, for example, country A is hit by a positive demand shock while country B experiences a positive supply shock, the need for real exchange rate adjustment is especially large: there has to be a large real appreciation of country A vis-à-vis country B. It is necessary to look at demand shock correlations and supply shock correlations separately (as, for the first time, Bayoumi and Eichengreen did in 1993).

Finally, have U.S. economists been too skeptical about EMU, as Jonung and Drea suggest? EMU has indeed happened, but has it performed so well? And how will it evolve in the future if it lasts?

Monetary policy affects the inflation rate with a lag of two to three years.⁴ Thus, the low consumer price inflation rates of 1999 and 2000 (1.75 percent on average) were inherited from the German Bundesbank. From 2001 to 2008, inflation in the eurozone has been 2.3 percent per annum on a compound average basis. This is more than in Denmark (2.1 percent), Norway and the United Kingdom (both 1.9 percent), Sweden (1.8 percent) and Switzerland (1 percent)—in other words, more than in any other West European currency area with an independent central bank. In each year, the European Central Bank has exceeded the upper limit of its inflation target, which has always been 2 percent (see Table 1). Moreover, owing to the need for real exchange rate adjustment, five EMU member states (Greece, Ireland, Netherlands, Portugal, and Spain) have suffered from annual inflation rates in excess of 3 percent in several years. Table 1 also shows that the four East European EU member states that have pegged their currencies to the euro have experienced even higher inflation rates—up to 15 percent in Latvia in 2008—due to the Balassa effect.

4. See the evidence in the ECB *Monthly Report* of July 2000, 59.

Table 1: Consumer Price Inflation

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|---|-------------|-----------------|------|------|------|------|------|------|
| Euro area | 2.4 | 2.3 | 2.1 | 2.2 | 2.2 | 2.2 | 2.1 | 3.3 |
| <i>Euro area members</i> | | | | | | | | |
| Greece | independent | | 3.4 | 3.0 | 3.5 | 3.3 | 3.0 | 4.2 |
| Ireland | 4.0 | 4.7 | 4.0 | | | | | 3.1 |
| Netherlands | 5.1 | 3.9 | | | | | | |
| Portugal | 4.4 | 3.7 | 3.3 | | | | | |
| Spain | | 3.6 | 3.1 | 3.1 | 3.4 | 3.6 | | |
| <i>EU member states pegging to the euro</i> | | | | | | | | |
| Bulgaria | 7.4 | 5.8 | | 6.2 | 6.0 | 7.4 | 7.6 | 12.0 |
| Estonia | 5.8 | 3.6 | | 3.0 | 4.1 | 4.4 | 6.6 | 10.4 |
| Hungary | 9.1 | 5.3 | 4.7 | 6.8 | 3.5 | 4.0 | 7.9 | 6.0 |
| Latvia | | not yet pegging | | 6.2 | 6.9 | 6.6 | 10.1 | 15.3 |

Note: Only individual countries and years with inflation of 3 percent or more are shown.

What is most worrying, however, is the series of institutional and procedural changes that has taken place in EMU since 1999:

1. In May 2003, the European Central Bank raised its inflation target from a band of zero to two percent (with an ideal point of 1.5 percent⁵) to 1.99... percent.
2. Instead of modifying the monetary reference rate in response to the permanent portfolio shift that lowered velocity in 2002⁶, the European Central Bank demoted it to low rank in May 2003 and effectively abandoned it in 2007.
3. In March 2005, the Stability and Growth Pact was watered down beyond recognition.
4. In 2006, the European Central Bank's research department, which had been directed by Otmar Issing, a German conservative, was given to Loukas Papademos, a Greek socialist. Papademos has suggested that inflation is not a monetary phenomenon but a consequence of low unemployment (Modigliani and Papademos 1976), and he immediately organized a conference aiming to show that the money supply does not matter.

These changes amount to a trend. They suggest that the future of the euro will not be like its past. The initial choice of the institutions, the rules and the

5. For the derivation see, e.g., Vaubel (2004, 153).

6. For the econometric evidence, see Hofmann (2008).

persons governing EMU was made in a very special historical setting. The overture to the euro-game was special because one country, Germany, enjoyed veto power. Without German assent, EMU would not have started. Even though Chancellor Kohl had committed Germany to monetary union in December 1989 in principle, the implementation of that promise was a matter of negotiation up to the very end. The German government, based on a coalition of Christian Democrats and Liberals, was the driving force behind the European Central Bank statute; it imposed the Stability and Growth Pact on its reluctant partners; it postponed the redistribution of seigniorage, which was costly to Germany; it carefully screened the candidates for the executive board, including the first president; and it made sure that the economic and research directorate would go to a German monetary conservative with a maximum term of office. Even though seven of the eleven participating states had socialist-led governments in 1998, European Central Bank president Wim Duisenberg was the only one of the six executive directors with a socialist background, and even he was known to be a monetary conservative.

Once EMU had started, the German veto was gone. Appointments and policies are no longer determined by the most inflation averse member-country—as they were under currency competition—but by the median. The first effects can be seen. They are the beginning of a major shift from initial conditions to the long-run politico-economic equilibrium of the game.

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