Monetary Power and Europe: EMU’s Role in Global Monetary Governance

Mattias Vermeiren
Department of Political Science
Ghent University
Universiteitstraat 8
B-9000 Gent
Belgium
Mattias.Vermeiren@UGent.be

Abstract

Although the issue of European monetary power has received much scholarly attention, research has focussed on the currency struggle between the US dollar and the euro. This article delves into the equally relevant yet neglected research question whether since the establishment of EMU Europe has increased its monetary power irrespective of the outcome of this currency struggle. Drawing on a Regulationist perspective on monetary power, it is argued that the interaction of EMU’s European-level neoliberal governance mode with divergent national-level regulation modes and accumulation regimes has produced an incoherent macroeconomic governance regime that prevents Europe from fully capitalizing on the increased macroeconomic policy capacity of EMU. This argument is elaborated by an analysis of two interrelated policy domains: (1) balance-of-payments management and (2) exchange rate policymaking.
Introduction

When in 1999 Europe’s Economic and Monetary Union (EMU) came into formal existence, the launch of the euro was seen by many commentators as the most important event in global monetary affairs since the end of World War II. The establishment of EMU gave rise to the question whether Europe would be able to project power in the global monetary system, in the same way as European trade integration and the formation of a European trade policy had buttressed European power in the global trading system. In this context, the key question scholars have raised is whether the euro will be able to challenge the pre-eminence of the US dollar in the future. Many prominent analysts were very optimistic in this respect. Nobel Laureate Robert Mundell, for instance, predicted that the euro would “challenge the dollar and alter the power configuration of the system” (Mundell 2000). More than ten years after its birth, scholars are more pessimistic about the euro’s capability to challenge the dominance of the US dollar. Although some economists predict that the euro will defy the US dollar as an international reserve currency in 15 years (Frankel and Chinn 2008), from an International Political Economy (IPE) perspective most scholars believe institutional deficiencies of EMU remain a major constraint (Cohen 2003; Vermeiren 2009; see Helleiner and Kirshner 2008 for an overview).

The issue of euro internationalization is certainly very important for the study of European monetary power. However, this paper aims to examine the equally relevant question whether Europe has increased its monetary power since the establishment of EMU – irrespective of the outcome of the currency struggle between the US dollar and the euro. As recent scholarship on monetary power suggests (Andrews 2006), this question refers to the extent European governments have been able to increase their macroeconomic policy autonomy in the global monetary system – particularly in the context of balance-of-payments pressures. As European states’ macroeconomic policy autonomy had become increasingly
weakened by global monetary developments (e.g. Strange 1988; Webb 1995), the strengthening of European monetary power through the introduction of the euro seemed to be an imperative endeavor. Drawing on a Regulationist perspective on monetary power, this article argues that the founding of EMU has not allowed Europe to fully capitalize the potential of increased policy autonomy. The reason is that EMU established a European-level neoliberal governance mode interacting with divergent national-level regulation modes. The resulting diverging national accumulation regimes make the formation of a coherent European macroeconomic governance regime – a necessary condition for Europe to take advantage of its increased policy capacity – a delicate undertaking. The absence of such a coherent governance regime nevertheless risks destabilizing both the Eurozone and global monetary system. This argument will be elaborated by an analysis of two crucial and interrelated policy domains in the global monetary system (1) the management of balance-of-payments imbalances and (2) exchange rate policy.

The article will be structured as follows. The first section provides a Regulationist perspective on monetary power and explains the establishment of EMU as an attempt to reconsolidate European macroeconomic policy autonomy in the context of a parallel shift from Fordism to Post-Fordism and from benevolent US monetary hegemony to coercive US hegemony. The second section analyses the European approach to balance-of-payments management and shows that European policymakers have repudiated responsibility for the widening global imbalances while neglecting the problem of internal imbalances. The third section analyses the European exchange rate policy and argues that the ECB’s de facto control over exchange rate policymaking has resulted into a bias towards euro appreciation that cannot be countered because of the lack of authority of the Eurogroup. The conclusion summarizes the incoherency of Europe’s macroeconomic governance mode.
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Seminal research – bundled in a recent volume edited by Andrews (2006) – has pointed out that the problem of adjustment to balance-of-payments disequilibria is central to any discussion of monetary power (see also Kirshner 1995; Webb 1995; Bergsten 1996: 12–45; Kaelberer 2005). As the costs of external adjustment are typically distributed asymmetrically across countries, the main function of monetary power is to avoid as many of these costs as possible. This can be achieved by, on the one hand, delaying adjustment by financing the external imbalance or, on the other, by deflecting the burden of adjustment onto other states. As Cohen (2006) argues, the ultimate foundation of monetary power is autonomy. Excessive imbalances automatically generate mutual pressures to adjust, representing a persistent threat to policy independence. Because adjustment usually implies a compromise of key policy goals, monetary power consists of the capacity to avoid the burden of adjustment to payments imbalances in order to realise these key policy goals. However, the main problem is that the monetary power literature employs a state-centric approach whereby the domestic foundations of these key policy goals are neglected. For that reason, this article suggests to combine the theory of monetary power with the Regulation approach (e.g. Aglietta 1979; Boyer 2000; Lipietz 2001) in order to account for the domestic political economy context in which the pursuit of monetary power is embedded. More specifically, it is maintained that the macroeconomic policy framework is embedded in a specific mode of regulation, implying that the capacity to avoid the burden of adjustment is committed to the consolidation of a particular regime of accumulation.

Although the Bretton Woods regime “became synonymous with a hegemonic monetary order on the dollar” (Cohen 1977: 96), monetary power was less important for the crystallization of the post-war national regimes of accumulation. First, US monetary hegemony could more or less be considered as benevolent for the reason that international
liquidity was injected through the gold dollar standard as a means to finance international trade and productive investment. Second, macroeconomic policies were protected from destabilizing cross-border financial flows through the promotion and imposition of capital controls (Helleiner 1994; Kirshner 1999). Macroeconomic policies in both the US and in Europe consisted of Keynesian demand management policies aimed at full employment and were part of the overall national modes of regulation and regimes of accumulation – termed “Fordism” in Regulation Theory. Fordism was the model of post-war capitalist development whereby a specific “mode of regulation” – a package of institutions which in the context of Fordism involved “a centralized and rigid system of redistributing productivity gains, stabilized by a network of collective bargaining, social legislation and the welfare state (the system of social security)” (Lipietz 2001: 18) – gave rise to a macroeconomic dynamic (a “regime of accumulation”) in which regular increases of labour wages created a sustained and growing market for mass production (Aglietta 1979; Lipietz 1987; Boyer 2000).

Several global development increasingly undermined the macroeconomic policy autonomy of European states throughout the 1970s and 1980s, bringing the issue of monetary power to the forefront of international monetary relations. First, the structural crisis of the Fordist model elicited important changes in the international environment, not the least of which was the transformation of the global financial order. The demise of Bretton Woods in 1971 marked a shift to flexible exchange rates among the world’s key currencies while global capital flows increased considerably as a consequence of financial liberalization and deregulation policies. Large exchange rate volatility and increased capital mobility “helped to undermine the Keynesian policies of the previous decades” (Dannreuther and Petit 2006: 106). Second, US monetary hegemony became less benevolent and more exploitative. From the beginning of the 1960s, growing current account and fiscal deficits indicated that the US had gradually adopted more self-centred foreign economic policies. Because of the global
attractiveness of US financial markets and the dominance of dollar in global markets, the US retained a hegemonic position in the global monetary order. US monetary hegemony increasingly relied on the exploitation of its unique “structural power” whereby “the US aimed to preserve its policy autonomy by encouraging foreign governments and private investors to finance and adjust to growing deficits” (Helleiner 1994: 114; see also Strange 1987, 1988; Webb 1995). In other words, while exchange rate volatility and capital mobility was increasingly hollowing out European policy autonomy, US structural monetary power supported the policy independence of the US.

Many analysts have suggested that US monetary hegemony has played a destabilizing role in the global monetary system (Block 1977; Helleiner 1994; Calleo 1982; Strange 1987; Webb 1995). On the one hand, US structural monetary power and its ensuing capacity to delay adjustment has promoted unilateral tendencies in macroeconomic policymaking, giving rise to escalating payments deficits and bringing about increased volatility in interest rates, exchange rates and global capital flows. On the other hand, the dominance of the dollar has supported its power to deflect the burden of adjustment onto other states. It has bestowed the US with a powerful “exchange rate weapon” that has frequently caused monetary turmoil among European states (Henning 2006; see also Helleiner 1994, 2006; Webb 1995). Dollar depreciation can encourage foreign governments to embrace macroeconomic policies that relieve pressure on the American external payments position. In this respect, the encouragement or neglect of a dollar depreciation by the US government has often compelled European states with significant trade linkages to the dollar area to pursue expansive policies in order to offset their loss in export competitiveness, thereby increasing demand for American products and relieving pressure on the American trade balance while destabilizing European monetary arrangements.
European states were thus confronted with two destabilizing forces in the global monetary system: global private capital flows and US structural monetary power. These forces not only helped to undermine the macroeconomic policy autonomy of European states but also interfered with their desire to create an internal market. In fact, as Henning (1998; 2006) argues, protection against disturbing US policies provided an underlying motive for European monetary integration: “Every major step forward in regional exchange rate and monetary cooperation was associated with US disturbances. In every case of disruption, US shocks were followed by efforts to strengthen intra-European monetary cooperation” (Henning 1998: 566). Although monetary unification was also seen as a neo-functionalist corollary of European economic integration, safeguarding European policy autonomy was indeed an important underlying purpose. The creation of a European currency was meant to shield European states against US unilateralism and global financial turbulences, leading to a “zone of monetary stability” as well as re-consolidating Europe’s lost policy autonomy on a pan-European level. Thus, European states were willing to surrender their economic and political “nominal” monetary autonomy in order to attain a real measure of collective and therefore “effective” autonomy within the global economy (Leyshon and Thrift 1995: 118; see also Gill 1992: 167-168).

There are several reasons why monetary unification can strengthen European policy autonomy. First, irrevocably fixing European exchange rates through monetary unification precludes the possibility that intra-European monetary arrangements can be disturbed by external influences – such as US policies and financial speculation. As such, European leaders can focus on domestic policy objectives without having to be concerned about distressing exchange rate fluctuations. Second, a flexible exchange rate for the new European currency allows the ECB to pursue domestic, intra-Eurozone objectives. This follows from the well-known monetary trilemma, which states that in a world with full capital mobility it is
impossible to have both a fixed exchange rate and autonomous monetary policy. Because exchange rate fluctuations of the euro against extra-regional currencies such as the dollar could be more easily neglected due to the intra-regional nature of most European trade, the ECB could pursue domestic objectives with relative neglect of the euro exchange rate. Third, on a national level monetary unification can grant individual member states the benefits of global capital market integration while minimizing the risks. According to Jones (2001: 273), EMU provides “a common solution to the problem of volatility – one that will preserve the macroeconomic flexibility afforded by capital market integration while at the same time making it possible to ignore substantial institutional differences between the member states.”

The idea is that monetary unification maximizes the benefits of increased access to international capital markets – relaxation of the current account constraints of its member states and therefore the improvement their policy flexibility – while minimizing the costs – exchange rate volatility.

From a Regulationist perspective, however, it is not clear in which regime of accumulation the improved policy autonomy is embedded. In other words, what is the social purpose of Europe’s increased monetary power? On the one hand, the EMU construction has institutionalized a self-limiting neoliberal mode of regulation that has placed definite limits on the macroeconomic policy independence of European governments (Cafruny and Ryner 2007; Huffschmid 2005; Martin and Ross 2004; van Apeldoorn 2002). The ECB can be considered as the most independent central bank of the world with an absolute policy priority to keep inflation below but near two percent. In addition, the Stability and Growth Pact (SGP) obliges EMU member states to keep their budget deficits below 3 percent of GDP and their public debt levels below 60 percent of GDP. As Gill (1998: 11) accordingly notes, EMU “can be comprehended as part of a set of policies that has shifted the European Union towards a neoliberal and financial, as opposed to a social market or social democratic, model of
capitalism.” This is also manifest in the trajectory of European financial integration, whose focus on the Anglo-American model of equity-based finance seeks to establish a finance-led accumulation regime in Europe (Bieling 2003; Cafruny and Ryner 2007; Cafruny 2010; Grahl 2001; Konings 2008).

On the other hand, EMU has not eliminated the diversity of the European national modes of regulation (Aglietta and Berber 2007; Amable 2003; Boyer 2010). Because “the heterogeneity of national regulation modes brings potential conflicts about the conduct of the monetary policy” (Boyer 2000: 39), this has significant implications for the extent to which Europe is capable of capitalizing EMU’s potential of increased policy autonomy. The institutional diversity of the national regulation modes among EMU member states can be seen by looking at various institutional dimensions: the financial/monetary regime, the wage labour nexus, the forms of the State and the forms of insertion into the world economy. On the basis of these institutional variations, this article distinguishes four models of capitalism in the Eurozone, each differentiated by a particular regime of accumulation:

- **The Anglo-American model** of market-led capitalism in which the market plays the decisive role with regard to coordinating economic activity. Highly developed and innovative financial markets and flexible, decentralized labour markets are central to the growth regime – generally referred to as finance-led accumulation regimes. Although in Europe the UK is traditionally associated with this variety of capitalism, Ireland has increasingly adopted this model over the past decade.

- **The Rhineland model** of coordinated capitalism in which powerful professional associations coordinate the process of wage bargaining, supporting an export-led growth regime that is based on quality differentiation and price competitiveness. This
model is traditionally associated with economies such as Germany and the Netherlands.

- The statist model of capitalism in which there is strong competition among unions not to accept any concession and in which the government has a central role to play in the fields of labour, competition and integration at the international level, supporting a growth regime that is mainly based on domestic demand. Particularly France is associated with this model.

- The Mediterranean model which is also characterized by a large public sector, rigid labour markets. Although in the 1980s these economies were labelled as “peripheral Fordism” (Lipietz 1997), today they are particularly known for their hybrid regulation modes – combining elements of other regulation modes. In general, this has not favoured their international competitiveness.

This article argues that the present EMU constellation is restraining Europe from capitalizing EMU’s potential of increased policy autonomy. The reason is that EMU’s interaction between the European-level neoliberal governance mode and the national regulation/growth modes prevents the formation of a coherent European-level macroeconomic governance regime that is able to proactively deal with global monetary developments in a way that is conducive to the stability of both the Eurozone and the global monetary system. This argument will be elaborated by an analysis of two interrelated policy domains: (1) the management of balance-of-payments and (2) the management of the exchange rate of the euro.

**EMU and the Management of Current Account Imbalances**

Over the past decade the global monetary system has been characterized by escalating global current account imbalances between the United States and East Asia. The widening of these
imbalances since the end of the 1990s and their unprecedented magnitude – in 2006 the US ran a record external deficit of 6.5 per cent of its GDP – entailed an exceptional increase in US indebtedness. It is important to note that the emergence of these imbalances has been a function of continuing US monetary hegemony (Schwartz 2009; Vermeiren 2010). The East Asian financial crisis induced emerging markets to pursue export-led growth strategies aimed at the accumulation of US dollar-denominated reserves. This has allowed the US to delay external adjustment, while supporting expansion of the US economy based on massive capital inflows, rising asset prices and debt-financed consumer spending. US monetary hegemony has therefore promoted the consolidation of a finance-led accumulation regime in the US economy that has allowed the US to play the role of global consumer of last resort, thereby underpinning and crystallizing East Asia’s export-led accumulation regime.

[Insert Figure 1]

Although many analysts correctly believed that the rise in US deficits and debts was unsustainable – there is now a growing consensus that the escalation of global imbalances have played a major role in the global financial crisis – European policymakers were not overly concerned about the problem. The ECB downplayed the responsibility of the Eurozone for the adjustment of the global imbalances. Although ECB official Otmar Issing (2005: 2) noted that “the threat of global imbalances clearly concerns every single actor in the global economy, and all parties involved therefore need to take their part in resolving the issue”, he emphasized that “most European countries, and in particular in the euro area, have a current account that is in balance … which is fully in line with Europe’s economic fundamentals” (Issing 2005: 15). The Eurozone’s current account was indeed approximately in balance over the past decade (Figure 1), yet European policymakers nevertheless participated in the IMF-
sponsored Multilateral Consultation on Global Imbalances between China, the Eurozone, Japan, Saudi Arabia, and the US. It was acknowledged that the Eurozone could contribute to the orderly unwinding of the imbalances by strengthening its anaemic economic growth. However, this objective would not be realized by increasing domestic demand through macroeconomic policy expansion. Boosting growth by the implementation of supply-side structural reforms in the European product, financial and labour markets was the only commitment Europe was prepared to make as part of the multilateral effort to reduce global payments imbalances.

Two weaknesses in the European approach to the global imbalances indicate that the interaction between the European-level neoliberal governance mode and the diversity of national-level regulation modes has prevented EMU policymakers from playing a more powerful role in the management of global imbalances. First, it is doubtful that structural reform is the only action the EMU could or even should undertake. Several analysts argue that global rebalancing requires the Eurozone to adjust its fiscal and monetary policies. While agreeing with the ECB’s view that Europe was not part of the global imbalance problem, Ahearne and von Hagen (2006) contend that it was nonetheless bound to be part of the solution. In their view, the ECB should have been determined to loosen monetary policy promptly and aggressively, whereas fiscal expansion in Europe should have mitigated the effects of the decline in demand resulting from the US current account adjustment. Others argue that the Eurozone is not only part of the solution but also part of the problem, since Europe’s macroeconomic policy regime has prevented the region from playing a greater role in world demand (Arestis and Sawyer 2007; Bibow 2007; Subacchi 2005). Subacchi (2005: 17) thus claims that it is necessary for the Eurozone “to switch focus from an export-led to a demand-driven pattern of growth and therefore promote a policy strategy that is geared to domestic demand.” On the European level, however, the switch from export-led growth
toward demand-driven growth has been inhibited by the neoliberal orthodoxy of EMU’s macroeconomic policy regime.

[Insert Figure 2]

This latter perspective reflects the second – arguably the most important – weakness of the European approach to balance-of-payments management. Although the external current account of the Eurozone was more or less in balance over the past decade, escalating internal regional imbalances have been neglected (Figure 2). While countries as Greece and Spain have been running current account deficits of respectively 14 percent and 10 percent of GDP, Germany has seen its current account surplus rise to almost 8 percent of GDP in 2007. In general, it is particularly noticeable that the continental Rhineland countries have been running increasing surpluses over the past decade, while the Mediterranean countries and Ireland have been running increasing deficits. France is the only country whose current account has shifted between surpluses and deficits but was overall approximately in balance.

The partition of these country groups between surplus, deficit and balanced countries can be attributed to the heterogeneity of the national modes of regulation and growth regimes within a neoliberal-led EMU. Germany’s regulation mode – sector-level coordinated wage bargaining, central bank independence, prudent fiscal policymaking and a high level of integration in the world economy – has traditionally favoured a growth regime with a strong export orientation (e.g. Brenner 2000; Boyer 2005; Jessop 2001). Over the past decade, however, monetary, fiscal and wage policies have heavily subdued domestic demand, making German accumulation strategy ever more dependent on the growth of net exports – according to an IMF paper, since 1999 about 80 percent of real GDP growth in Germany was generated from net exports (Danninger and Youtz 2007). Because the ECB can only address average
inflation and therefore could not take into account Germany’s higher output gap and lower inflation than the Eurozone average, the ECB’s monetary policy was generally too restrictive over the past decade. In addition, “despite the fact that the economic slowdown [from 2001-2005] was considerably worse in Germany than in the Euro area as a whole, ... Germany’s fiscal policy was more restrictive” (Hein and Truger 2006: 18; see also Lapavitsas 2010 et al: 32-33). However, the main part of the depression of domestic demand resulted from developments in the German labour market. In the context of structural reforms of the German labour market and welfare system (Cafruny and Ryner 2007; Grahl and Teague 2004; Menz 2005), Germany has been following a policy of wage moderation (Figure 3) that has boosted the international competitiveness of its export sector (Bibow 2007; De Grauwe 2006; Hein and Truger 2006; Flassbeck 2007; Lapavitsas et al 2010). While amplifying Germany’s current account surplus, these policies have also made its economic growth ever more conditional upon foreign demand.

[Insert Figure 3]

The increasing current account deficits of the Mediterranean countries and Ireland over the past decade – the Eurozone generally absorbs approximately 50 percent of German exports – indicate that foreign demand for German products has been very robust. The way in which the deficits of Spain and Ireland have emerged can be understood by exploring their

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1 Decreasing German wages relative to the Eurozone average has the effect of an effective real exchange rate depreciation. As such, through its policy of wage deflation Germany has devalued more than 20 percent in real terms against Portugal, Spain and Ireland since 1999. While nominal exchange rate changes between members no longer occur with the EMU, real exchange rates are still prone to change when wage and/or productivity trends diverge within the union. National wage policies and trends – by determining relative unit labor costs – have therefore become the main driving force behind intra-EMU exchange rates. No political will exist to address these divergences. As Bibow (2009: 8) notes, “It is thus quite ironic that co-ordination is conspicuous for its absence in this area given that intra-area exchange rates were supposed to be a ‘matter of common concern’ since the beginnings of European integration.”
respective regulation mode and accumulation regime. Although Ireland traditionally constituted a particular liberal market economy based on foreign direct investment of export-oriented foreign firms (Kirby 2008; Murphy 2000), its growth model over the past decade has been increasingly finance-led (Hay 2009; Connor et al. 2010; Honohan 2009). Since its entrance in EMU, Ireland adopted a private debt-financed growth strategy that was based on an unprecedented housing boom (Ireland experience a staggering 185 percent increase in house prices between 1997 and 2005). One significant driver behind this growth strategy was the relatively low interest rates following Ireland’s EMU entry. As Irish inflation levels since EMU entry have exceeded the EMU average, “the interest rate settings of the ECB have been consistently lower than those that would have been set by an independent Bank of Ireland with an equivalent remit” (Hay 2009: 466). Another key factor behind Ireland’s growth model was the enormous inflow of foreign credit (the Irish banking system’s external borrowing reached approximately 100 percent) combined with “a lack of regulatory or central bank action to stem this dangerous international credit inflow” (Connor et al. 2010: 12).²

Although Spain’s Mediterranean model is distinct from Ireland’s market-led model, it has followed a remarkably similar growth regime over the past decade (Fernandez-Villaverde and Ohanian 2009; Hugh 2008). Spain’s adoption of the euro resulted into negative real interest rates, inducing a surge in investment and housing. Indeed, “interest rates were negative in Spain from early 2002 until mid 2006, causing massive overheating in the Spanish economy, which sucked in millions of immigrant workers (5 million in 8 years – since the economy was running way beyond capacity) in order to fuel a huge property bubble which has lead to a level of national indebtedness” (Hugh 2008). Nevertheless, one key distinction between the Spanish and Irish model are the Bank of Spain’s stern financial regulations as a

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² Capital inflows were indeed promoted by a very light-touch tax and regulatory oversight regime, leading The New York Times to call Ireland “the wild west of European finance” (Lavery and O’Brien 2005).
result of which “Spanish banks appear to have escaped the direct effects of the global financial crisis” (Royo 2009). Other Mediterranean countries – particularly Greece and Portugal – did not have a real estate boom as Spain did but did experience a rise in consumption because of wage increases and especially a sharp increase in fiscal deficits.

Although diverging growth paths within EMU resulted into expanding internal imbalances, European policymakers were not very alarmed about the evolution. In a 2006 Quarterly Report on the Euro Area, the European Commission (EC) even claimed that the imbalances could be considered as “a beneficial by-product of the euro and European financial market integration”, as “[t]he widening dispersion has been partly driven by a trend towards financial deepening in some Member States which has allowed Member States with bigger financing needs to tap international capital markets more easily” (European Commission 2006: 25). To the extent that the EC was troubled by the imbalances, it focussed its apprehension on the deteriorating competitiveness and fiscal balances (in the case of Greece and Portugal) of Mediterranean countries. Nonetheless, the global financial crisis and its devastating impact on the Eurozone economies have brought the internal imbalances to the forefront of the policy debate. The crisis clearly demonstrates that rising internal imbalances are not really a reflection of EMU’s monetary empowerment – the increased policy flexibility due to relaxed current account constraints, as Jones (2003) suggests. Indeed, diverging growth regimes have brought about an instable and unsustainable configuration, giving rise to painful and conflictive adjustment pressures among EMU member states.

The Greek fiscal crisis has fuelled a heated debate about the distribution of the burden of adjustment within the Eurozone. Although in a 2010 Quarterly Report, the EC identified “persistent weakness in domestic demand” in countries as Germany “as a source of concern for the euro area as a whole as well as the well being of surplus countries themselves” (2010: 5), the main focus was again on deficit countries and the need to improve their export
competitiveness and budgetary accounts (European Commission 2010). This focus on adjustment by deficit countries is also shared by the ECB. Jean-Claude Trichet, president of the ECB, emphasized that deficit countries need to “bring their monitoring of cost competitiveness indicators, their structural reforms, and their fiscal consolidation efforts more into line with the principles and rules underlying the functioning of monetary union” (Trichet 2010). Another ECB official, Juergen Stark, was more explicit about the needed adjustment in deficit countries, claiming that they “must not only bring their deficits under control, but also enact a fundamental reorientation of their economic policy” by conducting a policy of wage deflation (quoted in Rohan 2010).

While French Minister of Finance Christine Lagarde openly questioned the sustainability of Germany’s export-led growth model based on wage deflation for the Eurozone as a whole (Hall 2010), Otmar Issing noted that “an approach that deliberately tried to reduce the competitiveness of one of the most successful exporters in world markets” by increasing wages “would look like a bad joke” (Issing 2010). This orthodox approach is also embodied in the proposal of Wolfgang Schäuble to establish a “European Monetary Fund” that would impose highly restrictive macroeconomic policy conditions on member states in need of liquidity (Schaüble 2010). It seems therefore that the Germany – herein supported by the ECB and to a lesser extent the EC – is not considering a reorientation of its macroeconomic policy framework and is requiring deficit countries to increase their competitiveness by implementing policies of wage deflation and fiscal consolidation. As such, it turns out that European reaction to the crisis is forcing deficit countries to adopt the German model by pursuing pro-cyclic deflationary policies that will further weaken domestic demand in the Eurozone. However, as debt-fueled consumption in deficit countries provided for a booming market for German exports, decreasing demand will certainly undermine Germany’s export-led growth regime (Wolf 2010a; Muchäu 2010). In addition, as Bibow (2010) notes,
“fiscal retrenchment in their key export markets across Europe is bound to backfire on Germany’s own fiscal position, both through trade and through the wreckage that debt deflation will mean to German banks.” Indeed, the current account deficits of Mediterranean countries were for a large part financed by German bank lending, heightening the risk of Mediterranean debt deflation or default for the German banking system (see also Lapavitsas et al 2010).

The asymmetrical approach to internal Eurozone imbalances will neither be conducive to the stability of the global monetary system. As Wolf (2010b) points out, this approach “would shift each country’s economic weakness to other Eurozone countries or, more likely, to the world, via a bigger Eurozone net export surplus.” However, efforts to strengthen growth by increasing the regional net export surplus of the Eurozone will likely fall into the “fallacy of composition” of export-led growth: constraints on global demand will produce excess capacity in key export industries with the inevitable result of global deflation (Blecker 2000). Indeed, the current constellation of unwinding global imbalances makes the prospect of sufficient global demand to absorb the Eurozone’s net export surplus highly unlikely. The world’s key deficit country and prime engine of global demand – the US – is currently undergoing a necessary deleveraging process as a result of the crisis.³ After its chief economic advisor – Lawrence Summer – uttered the need for the US to move to a growth model that is “more export-driven and less consumption-oriented” (Editorial Financial Times 2009), the Obama administration announced a plan to double US exports in the coming five years. At the same time, the global crisis has induced East Asian emerging markets to stick to their export-led growth regime: “The incentive for emerging market governments to maintain

³ Although the US government has chosen to minimise adjustment costs resulting from the decrease in US private consumer spending by sharply increasing government deficit spending, US public deficits spending cannot on a medium to long term basis substitute for the US private consumption spending as the powerful engine of global demand (cf. Guttmann & Plihon 2009).
competitive exchange rates and accumulate reserves should be reinforced by the current crisis. [I]f … emerging markets with large stocks of reserves perform relatively well, it will be hard to convince future finance ministers that they have sufficient reserves to insulate their economies from follies from industrialized countries” (Dooley et al. 2009: 309). In this global context, the attempt of the Eurozone to increase the region’s net exports will most likely be ineffective and contribute to global deflationary pressures, weak global economic growth and probably increased international trade conflict.

**EMU and the Management of the Exchange Rate of the Euro**

The interaction between EMU’s European-level neoliberal governance mode and diverging national-level regulation modes is also preventing the formation of an effective exchange rate policy for the euro. The main problem is the lack of effective authority of the Eurogroup in this policy domain. As EMU rules stipulate that the Eurogroup may “conclude formal agreements on an exchange rate system for the euro” (Article 219(1) of the Lisbon Treaty) and “formulate general orientations for exchange rate policy” (Article 219(2)), one may conclude that “the exchange rate policy of the euro is ultimately in hands of politicians rather than the ECB” (Salvatore 2002: 160). Nevertheless, because the Eurogroup’s exchange rate stipulations need to be “without prejudice to the primary objective of the ESCB to maintain price stability” and the ECB has to be consulted, the ECB is granted a *de facto* control over the euro exchange rate.

As the analysis of Henning (2007: 315-320) suggests, the constitutional ambiguity between the Eurogroup’s de jure control and the ECB’s de facto control over the exchange rate of the euro arose from the institutional dilemma between two opposing models of exchange rate policymaking EMU architects were faced with. In the “French model” government officials have ultimate authority over the exchange rate, whereas in the “German
model” the central bank assumes the dominant role. In turn, the conflict between these two models derived from the more central conflict over the domestic price-stability orientation and independence of the ECB. While advocates of the German model wanted to protect the ECB’s price-stability objective and independence from interfering exchange rate instructions of European governments, proponents of the French model hoped to rebalance the power between the finance ministries and the ECB by claiming political control over the exchange rate. The distinction between the French and German model of exchange rate policymaking is related to the differing regulation modes of France and Germany. While Germany’s “enabling state” (Streeck 2001) has traditionally not allowed private export-sector interest in an activist exchange rate policy to undermine the independence of the Bundesbank (cf. Henning 1994), the French “interventionist state” has been more willing to employ exchange rate policy as a means to stimulate the economy (Boyer 2001; Howarth 2000; cf. Henning 1994).

The subordination of European exchange rate policy to the domestic price-stability target implies that the euro is a floating currency whose value is determined by the interaction of foreign exchange markets and ECB monetary policy. As one ECB official emphasizes, “the absence of an exchange rate commitment allows the ECB to focus squarely on its euro area objective, which is the preservation of price stability” (Bini Smaghi 2009). The adoption of a flexible exchange rate system does not mean, though, that the ECB is totally indifferent to the external value of the euro. During September and November 2000, the ECB intervened in the foreign exchange markets in order to reverse the persistent euro depreciation to the dollar since its birth in 1999. However, the fact that the euro depreciation threatened to increase inflation provided the main rationale for ECB to intervene in the foreign exchange markets (Henning 2007: 329). As the analysis of Kalthenthaler (2003, 2006: 123-146) indeed suggests, the ECB’s exchange rate preferences are solely determined by its one-dimensional commitment to domestic price-stability. A corollary might be that the ECB will only pursue
an activist exchange rate policy in order to reverse an inflationary *depreciation* of the euro, while accepting and even welcoming an excessive euro *appreciation* because of its tempering effects on domestic inflation. As such, there is a real danger that the ECB’s exchange rate policy is biased against euro depreciation and towards euro appreciation, harming the competitiveness of the European of the tradable good and services sector and imposing deflationary pressures on the Eurozone economies (cf. Creel et al 2007). In this respect, it is important to note that not just exporting firms but also firms only serving local demand will face fiercer competition because of an appreciating euro.

[Insert Figure 4]

The overvaluation of the euro against the US dollar in 2007-2008 and towards the end of 2009 arguably reflects the appreciation bias of the ECB’s exchange rate policy (Figure 4). The unwinding of the global imbalances is the most important causal factor behind the appreciation of the euro. Although European policymakers were not very worried about the imbalances and downplayed the responsibility of the Eurozone, in 2006-2007 it had become increasingly clear that the euro was becoming the ultimate “adjustment variable” (Ahearne and von Hagen 2006). Despite the increasing negative consequences of the euro’s appreciation (Ahearne and von Hagen 2006), in July 2007 the president of the Eurogroup Jean-Claude Jüncker claimed the rise of the euro reflected European economic dynamism (Forbes 2008). A strong euro was therefore considered as an expression of financial market confidence in the European economy. Nevertheless, the French president, Nicholas Sarkozy, argued that the so-called “benign neglect” of the external value of the euro was unsustainable, contend that exchange rate policy needed to be “politicised” (Whyte 2007/2008). After it became clear that the euro did not stop rising, financial officials too started worrying. When in
March 2008 the euro reached a new high of almost $1.60 against the dollar, even Jean-Claude Trichet admitted to be “concerned about excessive exchange-rate moves” (Morarjee 2008). However, the ECB did not resort to any exchange-rate policy measures – exchange market intervention or monetary policy adjustment – that could have impeded the excessive appreciation of the euro.

The exchange rate of the euro did become a politically salient issue in the context of China’s reluctance to revalue the renminbi. Europe’s “long-standing indifference to the renminbi” (Pisany-Ferry 2008) came officially to an end when in November 2007 a European Troika consisting of Eurogroup President Jean-Claude Juncker, ECB President Jean-Claude Trichet, and European Commissioner Joaquín Almunia travelled to Beijing for their first direct bilateral consultations on monetary and exchange-rate matters. China’s currency policies became the centre of their attention because of the renminbi’s exchange rate peg against the US dollar, which implied that the euro was appreciating against both the US dollar and the renminbi. European policymakers therefore believed Europe was becoming the ultimate victim of China’s monetary mercantilism, as reflected by the rapidly deteriorating EU’s bilateral trade deficit with China.4 This view was reinforced by the decision of the Chinese government to re-establish a strong peg against the dollar in the summer of 2008 in order to protect its export sector from the fallout of the global financial crisis. Although the appreciation of the US dollar against the euro in 2008-2009 diluted calls for a stronger renminbi, the rise of the euro against the dollar and renminbi in the second half of 2009 led to another visit of the European Troika in Beijing to discuss China’s currency policies. These efforts have born little fruit, however.

4 As European Commissioner of Trade Peter Mandelson said in a November 2007 speech “the number that preoccupies Europe these days is $20 million dollars. Because that is how fast the EU-China trade deficit is growing every single hour. Fast enough to catch up with the US-China trade deficit in the next year or so” (cited in Pisany-Ferry 2008: 2).
What explains the lack of effectiveness of European exchange rate policy? Henning (2007) argues that the insulation of the ECB from political and societal exchange rate preferences inhibits interest group lobbying to address misaligned and unfavourable exchange rates, thereby preventing European policymakers from exploiting domestic protectionist demands to influence the exchange rate policies of foreign governments. Walter (2009) also notes that “[t]he Eurogroup of euro area finance ministers, established as a political counterweight to the ECB, finds it difficult to reach consensus and so lacks authority to the ECB.”

Because Eurogroup consensus and authority are indeed necessary conditions to counterbalance the ECB’s control over the euro exchange rate, the lack of consensus in the Eurogroup seems of primary importance in explaining Europe’s exchange rate inactivism. In this respect, it is important to note that an exchange rate policy goes beyond influencing foreign government to change their currency policies; it also refers to exchange market intervention and interest rate adjustment to influence the currency’s market value (Cartapanis 2005; Creel et al 2007). Yet, the lack of Eurogroup consensus is undercutting its capacity to push the ECB to implement policies that may offset unwarranted exchange rate fluctuations.

As mentioned earlier, this lack of consensus is partly related to differing national institutional preferences – grounded in different national modes of regulation – about the independence and mandate of the ECB, whereby France and Germany are the most important protagonists. When in September 2007, for instance, Christine Lagarde urged the ECB to take “action” to rebalance the euro, German Chancellor Angela Merkel emphasized Germany would “resist any attempt to challenge the central bank’s independence” (quoted in Thesing and Vits 2007). To the dissatisfaction of the German government, Nicholas Sarkozy also has a long track record of attacking the ECB’s neglect of the exchange rate of the euro.
The lack of consensus within the Eurogroup can also be attributed to the diverging vulnerabilities of national growth models to euro exchange rate fluctuations. The breakdown of members states’ trade by main destination and origin does not seem to have much explanatory value; all states but Finland sell more than sixty percent of their exports to other EU states (Table 1).\(^5\) It is the overall competitiveness of the export sector that determines the vulnerability of member states to an excessive euro appreciation. In this respect, Germany has neutralized the impact of a euro appreciation on the cost competitiveness of its export sector by pursuing a policy of wage deflation (Bibow 2007; Hein and Truger 2005). In addition, because many of its exporters lead specialist fields where brand and quality help fend off price competition, the competitiveness of the German export sector is less affected by currency appreciation. Another key factor behind the diverging vulnerabilities to euro appreciation is the product structure of the export sector. While Germany’s exports of high-valued capital goods have been highly complementary to China’s export-led economy, Italy’s and Portugal’s export sector – dominated by textiles, clothing and footwear – have suffered higher declines in market share due to export similarities with China (Ahearne and Pisany-Ferry 2007).

Taking into consideration these diverging views and vulnerabilities, it is not difficult to see why it is hard for the Eurogroup to speak with one voice and to challenge the authority of the ECB on exchange rate matters. Although the recent fiscal crisis in the Eurozone has led to a depreciation of the euro, the ECB’s appreciation bias will most likely push the euro to overvalued levels as soon as the Eurozone’s fiscal turmoil is resolved.

\(^5\) It is interesting to observe that countries with a significant trade links with the dollar bloc (the US and China), such as Ireland (exporting 19.1 percent to the US in 2008), have not been particularly activist concerning the exchange rate of the euro.
Conclusion

This paper has argued that the interaction of EMU’s European-level neoliberal governance mode with divergent national-level regulation modes has prevented Europe from fully capitalizing on the increased macroeconomic policy autonomy the introduction of the euro would entail. This argument has been elaborated by an analysis of Europe’s approach to balance-of-payments management and exchange rate policy. With regard to former policy dimension, European policymakers have neglected that divergent national modes of regulation and growth regimes within a neoliberal-led EMU have given rise to the escalation of internal current account imbalances. While the export-led growth regimes Rhineland countries – led by Germany – have produced increasing current account surpluses, Mediterranean countries and Ireland have been running increasing deficits. The global financial crisis has accentuated the instability of this monetary constellation, bringing about increased conflict over balance-of-payment adjustment. The dominant approach to the problem of internal Eurozone imbalances has been to force macroeconomic policy restriction onto deficit countries with the objective of strengthening the export competitiveness of the Eurozone. It was argued that this approach risks producing deflationary pressures that will most likely destabilize the Eurozone as well as the global monetary system.

In addition, this article has argued that divergent national regulation modes have undermined the capacity of the Eurogroup to reach consensus and claim authority over exchange rate matters, granting the ECB de facto control over EMU’s exchange rate policy. The ECB’s neoliberal focus on maintaining price stability has generated a bias in EMU’s exchange rate policy towards euro appreciation. Taking into consideration that EMU policymakers are attempting to institutionalize a European-wide export-led accumulation regime as a result of the global and European financial crisis, EMU’s approach to balance-of-payments management is therefore clearly inconsistent with its approach to exchange rate
policymaking. Hence, EMU’s current macroeconomic governance regime has not produced a coherent European-level mode of regulation and accumulation regime in which the pursuit of European monetary power can be embedded. This will weaken Eurozone economic growth, intensify deflationary pressures, heighten tensions between EMU member states and might in a worst case scenario even lead to the disintegration of the Eurozone.

References


Figure 1: Current Account Positions of Selected Economies, 1997-2008

Source: IMF World Economic Outlook Database

Figure 2: Current Account Positions of Selected EMU member states, 1999-2008

Source: IMF World Economic Outlook Database (in billions of US dollar)
Figure 3: Nominal unit Labour Costs of Selected EMU member states, 1999-2008

Source: AMECO (1995=100)

Figure 4: Euro-US Dollar Exchange rate, 1999-2009
Table 1: Trade of Selected EMU member states within EU

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<thead>
<tr>
<th></th>
<th>Export EU</th>
<th>Import EU</th>
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<tbody>
<tr>
<td>Belgium</td>
<td>77.1</td>
<td>70.3</td>
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<tr>
<td>Finland</td>
<td>55.9</td>
<td>53.4</td>
</tr>
<tr>
<td>France</td>
<td>63.6</td>
<td>60.3</td>
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<tr>
<td>Germany</td>
<td>63.7</td>
<td>58.5</td>
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<tr>
<td>Greece</td>
<td>64.0</td>
<td>54.9</td>
</tr>
<tr>
<td>Ireland</td>
<td>62.3</td>
<td>63.6</td>
</tr>
<tr>
<td>Italy</td>
<td>57.9</td>
<td>53.1</td>
</tr>
<tr>
<td>Netherlands</td>
<td>76.2</td>
<td>55.0</td>
</tr>
<tr>
<td>Portugal</td>
<td>68.6</td>
<td>69.2</td>
</tr>
<tr>
<td>Spain</td>
<td>68.0</td>
<td>55.4</td>
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</tbody>
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Source: WTO Statistics Country Profiles (in percentage)