1 Introduction: EMU and the European social model

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The political structure of the European economy has been fundamentally transformed by the two decades of monetary integration culminating in Economic and Monetary Union (EMU). Centuries-old national currencies were replaced by the Euro and monetary policy, a core function of the modern state, was transferred to a supranational European Central Bank (ECB). The ECB was endowed with more autonomy from EMU’s member states than any other European Union (EU) institution except the European Court of Justice (ECJ) and greater independence than any other central bank in the world. The Stability and Growth Pact (SGP), also applicable to member states remaining outside EMU in addition limited member states’ discretion over fiscal policy, their remaining macroeconomic policy instrument.¹ There is no other policy domain where centralization of power in EU institutions has gone so far.

In contrast, the EU’s treaty/constitution leaves authority over welfare state and employment relations institutions in member state hands. These institutions largely shape individuals’ relation to the economic life of their societies throughout the life course, before, during, and after participation in the labor market. Despite important national differences, these institutions have enough in common in European countries, Britain excepted, to be understood as variants of what Europeans typically refer to as a “European social model.” This model is distinguished from the American, or Anglo-Saxon, model by its greater protection against economic insecurity, inequality, and unilateral employer power. Much domestic political conflict and partisan competition is focused on the distributive and normative issues raised by these social models.

These two different institutional arrangements create an EU polity that sharply separates authority over macroeconomic policy from that governing social models. The two domains are highly interdependent,

¹ While the 1997 SGP was subsequently incorporated into the Treaty of the European Union (TEU), its operation depends on decisions by the Economic and Financial Council (ECOFIN), comprising member states’ finance ministers, which failed to agree on enforcing it against violations by France and Germany (see chapter 3 in this volume).
Macroeconomic policy significantly affects the burdens on and resources available to social policy. It also helps shape the distribution of bargaining power among labor market actors. In turn, welfare state and employment relations institutions condition the impact and effectiveness of macroeconomic policy measures.

Throughout the first three postwar decades these two policy domains interacted within national political economies. Issues raised in both were contested in the same political arenas and by broadly similar democratic political constellations. To some extent, policies for each domain mutually reinforced one another, as captured by the term “Keynesian welfare state.” Economic growth, helped by government commitments to full employment, provided resources for growth in monetary and social wages, assured demand for increased output, and dampened conflict over distribution. Broad political support for national variants of the European social model flowed from this. Now that power over key macroeconomic policy decisions has been shifted away from the national political arenas in which social model issues are decided, however, the question is whether the macroeconomic foundations of the European social model will be maintained. This is the basic question addressed in this volume.

Expectations that European integration could threaten national social protection and labor market regulation is not new. Indeed it was evident from the very start of what became the EU. Negotiations for the 1957 Rome Treaty succeeded only because France, fearing that the proposed customs union would undermine its forms of social protection, won significant concessions on social and agricultural policy. As it turned out, the customs union and national social models then growing to maturity coexisted fruitfully. When the original Common Market gave way to the single market program in the 1986 Single European Act (SEA), anxiety was renewed. The SEA aimed to remove non-tariff barriers (NTBs) and assure the free movement of “goods, services, capital, and labor.” In time, this was meant to transform Europe from separate national economies linked within the Common Market to a genuine single economy. Many feared that the results might undercut national capacities and practices in social policy areas, particularly through “social dumping.” Development of the single market thus far has not confirmed these fears.

Any threat that monetary union, the third and biggest step in European integration, might pose does not flow automatically from the single currency and centralization of monetary and exchange rate policies. For European countries, the utility of national monetary instruments was already greatly circumscribed by volatile international financial markets.

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2 The mutually reinforcing character of policies in the two areas was emphasised in the French régulation and similar literatures. See Marglin and Schor (1990).
and, within Europe, the dominance of the German Bundesbank (Buba). Monetary union was an alternative. The incorporation of the separate European economies within a large, relatively closed regional economy with a single currency could provide a degree of insulation from disturbances in the international economy, while management of the currency by a supranational central bank would eliminate Bundesbank power. In principle, therefore, prospects for reducing the high unemployment that Europe had suffered since the 1980s could improve. This could in turn facilitate the reconfiguration of the European social model to preserve high social protection and labor standards, improving their equity and efficiency, and adapting them to new needs.

Whether or not monetary union actually achieves such positive results depends on its specific design and operation. Our analysis suggests that it may not, and that the intergovernmental politics of monetary integration has channeled EMU in a direction that is more likely to threaten the European social model's viability than to facilitate its rejuvenation. Our major reason for claiming this (elaborated in chapter 2 in this volume) is that EMU’s dedication to price stability, and the ways in which the ECB is likely to pursue this dedication, will keep EU employment levels lower than those needed to nourish the European model. On the other hand, our analysis also suggests that national variants of the European model have considerable resilience, and that the national politics of social model change may refract the pressures generated by EMU in directions that preserve high degrees of social protection and labor rights. How the tensions between highly centralized macroeconomic policy and decentralized national social model policies play out is contingent on the dynamics of domestic politics, which are likely to feed back into the continuing evolution of monetary union, as demonstrated by intensified controversy over the SGP in 2003. But as also demonstrated by this controversy, conflicting interests of member states can create stalemate and possibly even crisis in the construction of Europe.

These conclusions, cautious and tentative as they are, flow from the exploration of the tensions between monetary integration and national social models in this volume. In this introduction, we first sketch the politics of monetary integration that gave monetary union the form it has. Then we discuss the European social model and the politics of change in its national variants. Finally, we indicate how the interaction of these two streams of politics will be analyzed in the chapters that follow.

1 Europe and the politics of monetary integration

From the rubble of the Second World War, the architects of European integration came to believe that binding European nations to one another
was the best way to achieve lasting peace. Directly joining European states within a common political structure, such as a “United States of Europe,” was unrealistic, however. The strategy that emerged was to pursue common economic projects and build new European institutions to carry them out. This meant that each step in European integration was contingent on a confluence of economic interests, as perceived by governments and key domestic actors.

Monetary integration did not reach the agenda until European institutions had been built around other economic projects. The first application of the economic approach was the European Coal and Steel Community (ECSC) in 1951. The Rome Treaty of 1957, signed by the original ECSC six – France, Germany, Italy, Belgium, the Netherlands, and Luxembourg, then added the European Economic Community (EEC) and Euratom. The institutions that the Rome Treaty established – Council of Ministers, Commission, Parliament (EP), and Court (ECJ) – provided the basic political structures until EMU added the ECB.

The EEC, or Common Market, placed the member states within a customs-free zone for trade in manufactured goods with a common external tariff, special arrangements for agriculture (the Common Agricultural Policy, CAP) plus a few other common policies. The Common Market stimulated trade between member states and more rapid economic growth and modernization in general, helping to carry Western Europe’s postwar economic boom to its apogee. Intra-EEC politics in the 1960s, in particular French objections to supranationalization, assured that the Common Market was compatible with national development paths and the large degrees of national autonomy that went with them.

The first important initiative toward monetary integration was the 1970 Werner Report proposing that EMU be achieved in three stages by 1980. Before this proposal could get very far, however, Europe’s economic world changed dramatically. Inflation shot up, fueled by American policies around the Vietnam War as well as internal European factors, such as labor militancy, and the American abandonment of the Bretton Woods system in 1971 plunged the European monetary world into confusion.
The ensuing economic crisis was aggravated by the first Organization of Petroleum-Exporting Countries (OPEC) oil shock, which was simultaneously contractionary and inflationary. The divergent policy responses of EU members challenged the European Community’s fragile equilibrium, making it virtually impossible to decide anything, let alone innovate. Implementing the Werner Report was thus forgotten.

European monetary relationships nevertheless stayed on the agenda because of dangers to EEC and national stability from fluctuating exchange rates. A series of efforts was made to stabilize exchange rates among the increasingly integrated European economies, including a joint float against the dollar, “snakes” linking a varying set of European currencies to each other, and the European Monetary System (EMS), established in 1978. The fundamental difficulty these efforts encountered stemmed from diversity in inflation rates. This produced recurrent conflicts over responsibility for adjusting domestic economic policy to maintain parities between high- and low-inflation countries, most importantly between France and Germany. The German position – usually but not always that of the Bundesbank – repeatedly prevailed. This was crucial in shaping the course of monetary integration and assuring that it would be institutionalized in a form giving primacy to price stability.

The Bundesbank, freed from the obligation to support the D-mark:dollar exchange rate by the collapse of Bretton Woods, declared in 1973 that its monetary policy would henceforth be dedicated to domestic price stability. In fact, low inflation was integral to Germany’s highly successful export-based growth strategy but its effectiveness was contingent on exchange rate stability between Germany and its European trading partners. As long as Germany’s inflation was lower while nominal exchange rates remained unchanged, Germany’s exporters gained competitive advantage from real depreciation of the D-mark. This gave higher-inflation countries a stake in currency arrangements that imposed symmetrical adjustment obligations on both strong and weak currencies, while it gave Germany a stake in resisting such arrangements. Germany’s effort at combining internal and external nominal stability within Europe was further complicated by global exchange rate volatility. Germany needed to keep inflation differentials from being so large as to make intra-European exchange rate stability unsustainable. Whenever realignment became irresistible, therefore, Germany typically sought to minimize its

6 Wide fluctuations in the dollar’s value exerted divergent pressures on European currencies, mostly upward on the D-mark and downward on the higher-inflation countries. Besides straining intra-European parities, this resulted in capital inflows that had to be prevented from easing monetary conditions in Germany.
size and make it conditional on the adoption of disinflationary policies in the weak-currency countries.

Establishment of the EMS, the first actual step toward monetary integration, ended up strengthening Germany’s capacity to pursue these objectives. EMS originated in a deal struck by Helmut Schmidt, the German Chancellor, and Valéry Giscard d’Estaing, President of France. Schmidt, concerned about economic growth, sought to blunt upward pressures on the D-mark by bringing France, Germany’s largest trade partner, back into exchange rate coordination, after France’s second exit from the snake. Seizing the opportunity for France to recapture a leading role in Europe, Giscard also welcomed the external support for disinflation that coordination required, provided that the burden of adjustment would be shared, which meant more expansionary policy in Germany. Knowing the Bundesbank’s opposition to any arrangements impinging on its freedom of action, Schmidt initially bypassed it. But needing the bank’s support, he eventually agreed to technical provisions that “fundamentally altered how the EMS would operate over the coming years” (Henning 1994: 188).7

All EC member states belonged to the EMS, but only those who chose to participate were in the Exchange Rate Mechanism (ERM).8 Exchange rates of ERM members were defined bilaterally with one another, forming a “parity grid” which they were committed to maintain within +/− 2.25 percent.9 When currencies ran up against these limits, central banks were obliged to intervene. The D-mark was de facto at the center of the grid and divergence from the D-mark became the trigger to action, putting pressure on members to converge toward low German inflation rates rather than the higher average of all EC members. Exchange rates could be realigned if actions to support the rates were insufficient, but realignment required the unanimous consent of ERM members. This put Germany, and particularly the Bundesbank, in a position to make measures, typically disinflationary, a condition for allowing a devaluation by the “offending” country. De facto, therefore, through EMS the “Bundesbank took control of Europe.”10

EMS thus perpetuated the asymmetrical distribution of adjustment burdens. Renewed efforts by weak-currency countries to remedy this by

7 Heisenberg concludes that “the German government essentially used a bait-and-switch tactic to get the commitment of France to the system” (1999: 71). Although endorsed by a European Council resolution, the EMS was not formally an EC arrangement. Its rules were embodied in an agreement among EC central banks which were responsible for managing the system (Henning 1994: 189).
8 Britain stayed out until much later.
9 A +/− 6 percent limit in the case of Italy and new members.
10 The title of chapter 3 of Riché and Wyplosz (1993).
moving toward EMU were launched after the failure of the French Left experiment with “social democracy in one country” following the election of François Mitterrand in 1981 (see chapter 4 in this volume). The new French administration was initially committed to expansionary policies that challenged EMS and created new Franco-German tensions. By March 1983, facing EMS negotiation over a third devaluation, the French had to choose between pulling out of the ERM to salvage their post-1981 reformism, possibly ending EMS altogether and European integration along with it, or staying in and making its domestic policies consistent with the Bundesbank design for the EMS. Mitterrand made the second choice and the EMS survived. With that choice, France joined the countries switching to a price stability regime, albeit at a high cost for French employment. In time, France’s choice would become a strategy to strengthen the franc against the D-mark to reinforce French positions in EMS negotiations.

Having made this decisive “choice for Europe,” Mitterrand turned to regenerating European integration, opening the way for the new Jacques Delors-led European Commission that drafted the 1985 White Paper on completing the Single Market by 1992, followed by the SEA, ratified in 1987. The SEA made no provision for macroeconomic management, but the Commission succeeded in inserting vague references about European monetary policy (Article 102a). Moreover, the SEA’s commitment to the free movement of capital as well as goods, services, and people entailed the abolition of remaining exchange controls.

EMU officially re-emerged as a result of new Franco-German disagreements. As in the past, these were exacerbated by the disruptive effects of D-mark:dollar movements on intra-European exchange rate stability. After the 1985 Plaza Accord, which reversed the dollar’s extreme appreciation, the Bundesbank as usual refused to abandon its strictly German domestic point of view. This led French Finance Minister Edouard Balladur to come out for EMU, an ECB, and a single currency, adding that “the European Monetary System should resist the influence of countries with the most restrictive monetary policies” (Heisenberg 1999: 100). Hans-Dietrich Genscher, Germany’s Foreign Minister, welcomed the French initiative, to the Bundesbank’s dismay. In 1988, the European Council set up a committee to plan EMU. Chaired by Delors, it consisted of central bankers. This, as well as the pre-existing Committee of Central Bank Governors which later drafted the details, enabled the Bundesbank to press its position that any “future European monetary order . . . is not geared to stability to a lesser extent . . . than . . . at present in the Federal Republic of Germany” (Heisenberg 1999: 106). By insisting on provisions designed to assure that this would not be acceptable to other
governments, the Bundesbank anticipated that it could prevent EMU from ever happening.

The Delors committee’s Report (submitted in April 1989) incorporated many of the Bundesbank’s demands. The German government was divided, with some sharing the Bundesbank’s continued opposition to the whole idea. The international context after the fall of the Berlin Wall tipped the balance within the Kohl government, however. In exchange for the French supporting German unification (Mitterrand initially reacted negatively) the Maastricht EMU negotiations were scheduled to begin in the fall of 1990.

The resulting Treaty satisfied most German concerns. It created an EMU with a single European currency managed by a European System of Central Banks (ESCB) consisting of an ECB and member states’ central banks. Price stability was defined as the ESCB’s “primary objective.” The ECSB had also to “support the general economic policies in the Community,” including “a high level of employment and social protection,” but only insofar as this primary objective was attained (Articles 2 and 105). In addition, the Treaty left it up to the Bank to both define price stability and decide when and how it could support a high level of employment without prejudice to price stability. The degree of restrictiveness of the EMU regime would thus depend mainly on the Bank’s interpretation of its mandate, and the Bank was left free to interpret this mandate as it saw fit. Its legal basis in a treaty was changeable only by the member states’ unanimous agreement, making it the most independent central bank in the world. In addition, the independence of national central banks was made a condition for national membership in EMU.

Neither the ECB nor national central banks were to “seek or take instructions” from any EU bodies or member state governments, which in turn “undertake to respect this principle and not seek to influence . . .

11 All EU member central banks belong to the European System of Central Banks (ESCB) set up by the Treaty but central banks of non-EMU members (Denmark, Sweden, and the UK) do not participate in the ECB’s decision bodies. These are the Executive Board, consisting of the President, Vice-President and four other members, appointed by the “common accord of the Heads of State or Government” of the EMU member states, and the Governing Council, consisting of the Executive Board and governors of the member state central banks. These comprise the “Eurosystem” as opposed to the ESCB. The Council makes the monetary policy decisions. (ECB 2001c: 9–11).

12 This is almost exactly the formulation in the Bundesbank’s statute. It contrasts starkly with the US Federal Reserve Bank’s “dual mandate” to pursue not only price stability but growth and employment as well.

13 In contrast to a legislative majority, as in the case of other central banks, including the Bundesbank prior to EMU as well as the US Federal Reserve Bank and the Bank of England.
decision-making bodies of the ECB or of the national central banks” (Article 108).

The ECB’s independence was reinforced by what was omitted from EMU. Unlike other central banks, the ECB was not embedded in an institutional environment – a gouvernement économique, as French governments have sought – within which it shared political responsibility for macroeconomic policy, and it had no supranational fiscal policy counterpart. Fiscal policy was left in the hands of member states but the SGP strictly limited their ability to use it to combat recessions. The only formal mechanism concerning member states’ fiscal policies was the surveillance procedure by which the Commission and the Council of Economic and Finance Ministers (ECOFIN) monitored compliance with the SGP (chapter 3 in this volume). There were no mechanisms for coordinating the member states’ fiscal policies to construct a fiscal stance for Euroland as a whole, much less for coordinating fiscal policy and monetary policy to arrive at an optimal policy mix. Thus, while EMU severely constrained fiscal policy as a macroeconomic policy instrument – even tending to make fiscal policy pro-cyclical – it made macroeconomic policy for the eurozone as a whole the exclusive prerogative of an exceptionally powerful central bank.

There are Euro-level forums where the ECB must or may explain its decisions and hear criticisms: the EP, Commission, ECOFIN, the smaller informal Euro Group of EMU member state finance ministers, the Economic and Financial Committee which prepares ECOFIN and Euro Group meetings, plus the semi-annual Macroeconomic Dialog, where the ECB, the troika of Euro Group presidents, the two relevant Commission Directorates, and the European-level organizations of employers and unions meet to discuss the economic situation. But with one exception, none of these bodies has any authority over macroeconomic policy instruments, in none can binding commitments be made about any aspect of the policy mix, and in none of these contexts can there be negotiations over the eurozone policy mix with the ECB, which regards

14 The EU’s budget of 1.27 percent of aggregate GDP has little macroeconomic significance.

15 The ECB president may attend ECOFIN meetings (which include EU member states not belonging to EMU) and the ECOFIN President and a Commission member may attend ECB Board meetings, but none has voting rights in each other’s decision bodies. The ECB President or Vice-President is invited to attend the meetings of the Euro Group, which has no decision-making authority, however. The Euro Group has no formal legal status. The Macroeconomic Dialog was established by the 1999 Cologne European Council.
such negotiations as infringements on its independence.\footnote{Only ECOFIN has authority to make decisions binding on member states, primarily in the form of legislation within the EU’s areas of legal competence. It also adopts the annual Basic Economic Policy Guidelines (BEPGs), embodying recommendations for policy actions to member states, and not the ECB, largely aimed at securing budget discipline and not the coordination of fiscal policy as part of a eurozone macroeconomic policy mix. From the ECB’s standpoint, there can be no question of “ex ante” coordination of macroeconomic policy between other bodies and the ECB” (Issing 2002: 350–351). The Economic and Financial Committee of national, EU, and ECB officials which prepares ECOFIN meetings “consciously refrains from discussing the conduct of monetary policy” (ECB 2000d: 59). This is true of the Commission as well, though not of the EP or Macroeconomic Dialog meetings.} The exception is the Euro exchange rate, about which the Council is authorized to take positions by qualified majority vote, subject to consultation with the ECB to assure consistency with price stability.\footnote{This seems to have no practical significance, especially since the Euro floats against other currencies.} While no central bank, including the ECB, can entirely ignore the political context in which it operates, the ECB enjoys exceptional insulation from political actors subject to democratic accountability (Jabko 2001).

Maastricht, like the Delors Report and Werner Plan, specified a staged transition to EMU. The first stage was deemed already to have begun in 1990 with the liberalization of capital movement prescribed in the SEA. Stage Two would begin in 1994 with the creation of the European Monetary Institute (EMI) to monitor compliance with the five convergence criteria determining eligibility. The criteria were: inflation levels and interest rates close to an average of the three best records in the EU, annual budget deficits lower than 3 percent, cumulative debt less than 60 percent of GDP, and currencies that have been in the ERM “narrow band” for at least two years. EMU would go into effect in Stage Three. It could begin as early as January 1997 if a majority of member states were eligible but in January 1999 no matter how many qualified. Setting a fixed final date for movement to Stage Three was a last-minute victory for the French (backed by the Italians) that might have ensured that EMU actually happened, because passage through the three stages turned out to be very difficult.

Extremely contractionary Bundesbank policies in 1992 to counter inflationary pressures from unification dragged Europe into deep recession and EMS crisis. Potential EMU members suddenly faced much more daunting prospects. The Germans and the Bundesbank then tightened the screws even more, insisting in 1996 on the need for a “stability and growth pact” to continue key convergence criteria beyond the beginning...