THE POLITICAL ECONOMY OF MONETARY INTEGRATION IN THE EU AND IMPLICATIONS FOR CYPRUS*

Introduction

The European Economic and Monetary Union (EMU) in many ways constitutes a unique experiment in economic history, representing a case of monetary union without a comprehensive political union, but with a single currency and a common monetary authority. The EMU had run ahead of fiscal and financial integration and happened at a time of diverse economic records and circumstances in Europe. In the process, rather inevitably, considerable costs were created for several countries. However, multiple benefits have accrued to its member countries over time. The EMU has forged the necessary nominal policy anchor for macroeconomic stability, increased transparency, enhanced competition, and has helped develop integrated capital markets, induce structural change and stimulate productivity growth.

This paper looks at the European Union (EU) from a historical perspective and pays particular attention to the creation of the EMU and the relevant future challenges. Within this framework the paper assesses the potential political ramifications and implications. We also advance the position that in the long run for the euro to be successfully sustained and to also be a permanent leading international currency the EU must further advance its political integration. The paper also briefly considers the case of Cyprus' adoption of the euro and the political and economic implications. In the final section we put forward some concluding remarks with a special emphasis on suggestions for further research.

I. From the European Community to the European Union

Although the creation of the European Community (EC) is not independent from the overall dynamic process of the formation of regional economic blocs and even globalization, it is important to recall the conditions under which the

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* Speech by Professor Andreas Theophanous at the conference entitled **"The Critical Function of History in Banking and Finance"**, which was organized by The European Association for Banking and Financial History e.V. and hosted by the Bank of Cyprus on May 15-16, 2009 at Holiday Inn Hotel.

EC was founded. Europe had a long record of national rivalries and conflict; in the 20th century alone it had been devastated by two World Wars that started and were mainly fought on its soil. Following the Second World War and the rise of the Soviet Union a new set of circumstances was created. For the US it was imperative to contribute toward the reconstruction of Europe in the context of the American strategic objectives to maintain supremacy and leadership as well as contain the Soviet Union. On their part European leaders felt that the time had come for a new approach of cooperation and communality. Europeans realized that ethnic rivalries were not conducive to the promotion of their common interests. Consequently, with the initiative of France and (West) Germany, the traditional European rivals, a process of economic (and other forms of) cooperation began in the 1950s, which culminated in the Treaty of Rome in 1957.

Although the Treaty of Rome practically set up a Customs Union among six countries (W. Germany, France, Italy, Netherlands, Belgium, Luxembourg), in essence it paved the way for a much more ambitious project. At about the same time the European Free Trade Area (EFTA) was founded which had a less ambitious agenda as it was essentially concerned with advancing free trade. Over time the EC was successful in becoming much more influential and in the end almost all countries that originally belonged to EFTA joined the EC/EU. Britain which was the leading country of EFTA to the present day pursues a philosophy which does not encourage the political integration of the EU.

When the EC was founded in the 1950s its objectives, tacitly and implicitly, were the following:

- Reconciliation: to heal the wounds of the past
- To promote peace and security
- To create the conditions for the economic reconstruction of Europe
- To pave the way for the economic ascendancy of Europe
- To help contain the Soviet Union and the spread of Communism
- To sustain democratic institutions and human rights
- To promote the ultimate objective of the political unification of Europe and thereafter work toward assuming a protagonist role in world affairs.

By 1989 much had been achieved. Western Europe was successful in overcoming the divisions of the past and had also enjoyed an unprecedented period of peace and economic prosperity. The EU was successful in achieving a quick recovery from the ruins of the Second World War and also laid the foundations for its economic ascendancy globally. It must be acknowledged though that the contribution of the US for this outcome was very important. Furthermore, with the collapse of communism and of the Soviet Union, the fall of the Berlin Wall and the reunification of Germany a new era had begun.

Undoubtedly, there were at times different stumbling blocks which seemed to impede or rather decelerate the process of European integration. But the EC always found ways to move forward. For example, during the 1980s when the EC faced what came to be described as Euro-sclerosis, European leaders rose to the occasion and worked effectively in the direction of overcoming problems. The outcome was the Single European Act, which aimed at promoting a truly Single European Market. Europe 1992 became both an ambitious slogan and a new reality; in its turn this development contributed to a great extent to paving the way for the later adoption of the euro.

The EC/EU pursued a pragmatic approach, which aimed at maximizing the benefits subject to the existing constraints. The EU understood the difficulties of trying to simultaneously advance both widening and deepening but at the same time the Union realized that it would be losing the forest for the tree if it inflexibly chose to advance deepening at the expense of widening or vice versa. It was of vital importance for the EU to expand the security and prosperity zone. It is within this overall philosophical perspective that successive rounds enlargement should be understood. Nevertheless further expansion is now considered in a different light in terms of the absorption capacity of the EU.

Over time the member-countries learned the art of compromise and flexibility. The European institutions acquired an importance of their own in the eyes of national policy-makers as well as of people at large. And gradually it was both understood and accepted that a reallocation of powers, jurisdiction and authority between Brussels and the national capitals was a natural evolution of the continuous development of the EC/EU.

The EU has been repeatedly criticized for what it was not successful in doing. For example, it has been suggested that during the Yugoslav crisis, in the 1990s, the EU's actions proved to be inadequate in containing the crisis, the tragedy and the bloodshed in the Balkans. Although this criticism is valid it finally prompted the member states to seriously raise the issues of common foreign policy, defence and security at the EU level. This development despite its shortcomings confirms the perspective that the concept of the nation-state in the EU is undergoing a transformation.

II. The Advent of the Euro and the Economic and Monetary Union

As early as 1969 at the Hague European summit, the leaders of the 6 member states of the then EC agreed on the adoption of a common currency within the framework of an Economic and Monetary Union over a period of ten years. However, at the 1980 Luxembourg European Council meeting the EC heads of state abandoned the objective of completing the final stages of a European Monetary System within the initial timetable when it was realised that the target was too ambitious. Nevertheless, the important element was that there was a vision to move in the direction of a common currency.

As a result of both the adoption of the Single European Act and of full capital mobility it was becoming increasingly clear that the European Monetary System (EMS), which was adopted in 1979, was inadequate to meet the new challenges. The Treaty of Maastricht in 1992 marked a turning point in the process of European integration: the member states agreed to proceed toward a truly European Union with the completion of an Economic and Monetary Union (EMU) leading to the adoption of a common currency. This was also accompanied by a time schedule. However, there were serious reservations about whether this project would be successful.

Moreover, there was much criticism about the wisdom of such a move. According to Feldstein the adoption of a common currency made sense only if a political decision to move forward to a Federal Europe was taken. He argued that in the absence of such a vision and clear political objectives the adoption of the euro would create more problems than benefits. Among other things, he predicted the persistence of unemployment and, given the existence of asymmetrical shocks and different circumstances in each country, the emergence of a new set of developments which could cause considerable strife at both the European and international level.

Nevertheless, the idea of the EMU and the euro were received positively by others. The adoption of a common currency made sense from an economic perspective irrespective of the *a priori* existence or not of political objectives. According to Wyplosz the existence of a single market which was moving more and more toward further integration in conjunction with the existence of different national currencies would always lead to situations of currency crises, as an outcome of speculation or other fundamental factors. Certainly such outcomes could be counter-productive. Moreover, the adoption of a common currency could lead to price stability and harmonization, drastic reduction of transaction costs and would also contribute to the creation of a truly single integrated European market.

At the same time it should be stressed that the adoption of the euro created processes that could lead not only to further economic integration but also to the possibility of further political cooperation. The creation of the European Central Bank (ECB) and the introduction of the euro were thought of as potentially applying pressure to develop political mechanisms for holding monetary policymakers more accountable.

III. The Political Economy of the EMU: the Record and the Challenges

The EMU has generated many positive results and benefits for member countries: it has led to integrated capital markets, has supported a more stable economic environment by anchoring inflationary expectations, lowered borrowing costs across the board and thus underpinned considerable economic growth. This ultimately helped to advance the objective of real convergence (although much more remains to be done), thus reducing the marked disparities in per capita income levels. At the same time the elimination of transactions costs and increased price transparency further enhanced trade and benefited the consumers.

Following the marked devaluation of the US dollar in the period 2005-2008, the euro has come into focus as an alternative international currency. Consequently, the strength and governance of the new currency constitute areas of increasing interest in global finance. But the single currency in the framework of divided and/or shared sovereignty raises a number of issues and potential threats.

There is what may be described as the optimum currency area challenge, the fiscal challenge, the growth challenge and the financial stability challenge. Moreover, the fundamental question and challenge is whether in the long run the euro can be successfully sustained without further political integration. Alternatively put, the question raised is whether the euro will dynamically create a process which will lead to further political integration.

Lessons from the Past

Monetary unions in the past can generally be distinguished between two categories: national and multinational unions. Their experiences provide us with a number of useful lessons. Most importantly, national and multinational monetary unions were set up with broadly the same economic objectives: to facilitate trade by reducing transactions costs of currency exchange, reduce or even eliminate trade restrictions, reduce exchange rate volatility and prevent wasteful competition for seigniorage. National monetary unions were set up for the added political imperative of creating nation states.

Unlike national monetary unions, multinational monetary unions in the past did not survive the test of time. Multinational monetary unions (such as the Scandinavian Monetary Union) could not survive in an unstable international environment and with pressures on divergent paths regarding the optimal mix of national fiscal and monetary policies.

National monetary unions (i.e. US, Germany, Italy) have endured despite considerable strains reflecting the cohesion of their underlying nation states.

They also evolved into fiscal unions whereby considerable economic powers were transferred from the regional level to the national authority, either centralized or federal. Fiscal prudence and stability therefore emerge as necessary conditions for the viability of a monetary union.

The EMU is different from earlier experiences of monetary unification in a number of respects. Whereas multinational monetary unions in the past kept separate monetary authorities, the EMU has created a single currency and a common monetary authority. In contrast with national monetary unions, member states have kept a substantial part of their political sovereignty and also a large degree of fiscal sovereignty. A key potential problem is conflict among national agendas for growth and full employment. This problem of course is related to the incidence and severity of potential asymmetric shocks. It should be kept in mind though that political will toward greater political integration or the creation of cooperative fiscal arrangements will be vital for the underlying durability of the EMU.

Perspectives from the Optimum Currency Area Literature

OCA theory considers the conditions necessary for a monetary union with a single currency to be successful. Initially OCA literature focused on the trade related benefits of adopting the single currency. The conclusion was that the corresponding reduction of transaction costs would benefit national economies in direct proportion to their degree of trade openness.

Given the EMU and the adoption of a common currency and effectively common interest rates, national governments do not have the option of monetary discretion. In this framework it should be clarified that the adjustment process to shocks and monetary integration cannot be separated from the flows of all forms of resources.

It may also be important to revisit the role of the EU and its institutions and policy options. In the context of asymmetric shocks and other challenges there is scope for a common fiscal authority for transferring resources from the positively affected regions to the regions and countries adversely affected. Of course the role of a fiscal authority is not limited to this function.

The Fiscal Challenge

One of the most important questions raised relates to the impact of the adoption of the single currency on the fiscal policies of the countries of the Eurozone. The interdependencies of monetary and fiscal policies cannot be overlooked. Sargent and Wallace for instance, convincingly argued in 1981 that particular monetary objectives cannot be met irrespective of what is going on in the fiscal domain. The argument can of course be reversed. Fiscal objectives may not be independent of developments in the monetary domain.

From a practical perspective the adoption of the euro involves a policy of fiscal restraint. In the long-run this leads to extremely positive outcomes such as accountability in relation to how public funds are allocated and spent, pushing aside wasteful spending and thus promoting efficiency and so on. But in the short run, fiscal restraint may cause hardship and the adjustment costs may be high.

In the case of the EMU a fiscal union may evolve through a federal structure which would, inter-alia, involve the transfer of competencies and functions from the national authority to the supranational level. Fiscal federalism can offset the effects of asymmetric shocks thus adding to the operation of a monetary union. The transfer of more fiscal responsibility from the national level to a would be federal authority in the Eurozone seems to be necessary for the viability of the monetary union but one which is difficult to achieve.

The Growth Challenge

Long-term economic growth is ultimately critical for the long-term viability of the monetary union. Low growth per se or variable growth rates across member countries lead to conflict and apply political pressures over issues of the common monetary policies.

High rates of economic growth tend to reduce fiscal imbalances thus aiding the effectiveness of the single monetary policy. By the same token low rates of economic growth heighten fiscal imbalances making a common monetary policy more controversial as the needs of individual member countries begin to diverge. The ageing of the population and the rising health costs will be imposing added fiscal strains.

The next five to ten years will be particularly challenging for the EMU. This is because growth rates may be slowing and also, more importantly, because growth differentials may be widening. Nevertheless, much remains to be done in the direction of further economic and political integration for the EMU to be successful in the long run.

The Financial Stability Challenge

At the same time, financial sector shocks can potentially undermine monetary regimes and discredit central banks responsible for their operations. The Eurozone is an integrated capital market with a common currency and monetary authority. Yet the regulatory framework is in the hands of the national authorities. As a result the extent to which the regulatory framework can provide preventive supervision is limited. That is, there is no central body or authority that would be aware of banking problems from early on. However, shifting supervision to the supranational level may have practical difficulties given the current institutional arrangements.

III. The Political Economy Challenge: Economic Ramifications and Political Implications

The adoption of the single currency encourages the deeper integration of all the economies in the Eurozone. In the long run this would, through different processes, lead to a more efficient, thus more competitive, economic structure. It should be also noted that the adoption of the euro involves essentially the transfer of competencies in several areas from each nation-state to the EU and its institutions. This in turn raises expectations regarding the role of the EU as a supra-national structure. This issue may well involve political implications also.

While in the past there have been cases of strong powers and weak currencies, there has never been a case of a strong currency without a state. The implication is that, with the adoption of the euro, the EU has irrevocably entered a path, which will lead to more changes. More specifically, the EU may have to adopt a modern constitution and also promote a common foreign and security policy. In other words, if the hypothesis that for the best possible performance of a currency in the international arena, a full political entity is a necessary though not a sufficient condition is correct, the EU will have to fully advance its political institutions and move toward the direction of further political integration.

It may also be interesting to assess the impact of adopting the common currency (the euro) on identity in the current and future members of the Eurozone. Future generations that will not have gone through the experience of national currencies but will be using and sharing the euro, may have a higher propensity to put more emphasis on the European identity.

Given the historical experiences with financial and currency crises, we may also note that fiscal strains and low economic growth constitute major risk considerations for the EMU and the single currency. On the other hand such circumstances tend to enhance the need for solidarity and coordination. Whilst the welfare state can be the basis of much social stability and economic resilience in Europe, the classic trade off between social welfare and economic efficiency sets limits on the extent to which the welfare state can reach.

Government finances are coming under severe strain as a result of two interconnected developments. On the revenue side there is increasing pressure in a globalised world to reduce corporate tax rates. On the spending side a number of interrelated factors – the ageing of the population, rising medical costs, and rising demand for public services in general – are straining public finances. Lack of coordination of national fiscal policies may create a serious threat to the single currency.

The long run success of the euro also critically depends on a sustained rate of real growth. Low growth or markedly variable growth rates across different regions and countries would generate political strains against the euro.

The euro has *de facto* evolved as the second reserve currency of the world. However, the euro stands in contrast to the dollar in a number of respects. Unlike the dollar, the euro is not the currency of a superpower. The euro is held for the purposes of diversification and for political reasons. More importantly, it is not dependent on continued capital inflows like the dollar.

Coming back to the issue of whether the euro itself will pave the way for further political integration it is important to note that during the deep international financial and economic crisis of 2008-2009, the euro proved to have ameliorated the negative impact in the countries of the Eurozone. The multidimensional usefulness of the euro is very much understood and complaints about loss of national monetary and economic independence are gradually put aside. The sustainability of the euro while at the same time trying to achieve other economic objectives is the core issue. These dynamics raise *de facto* the issue of further economic deepening and political integration. Even if not all of the countries of the EU and even of the Eurozone may be interested in discussing the further economic and political integration this will be undertaken by some countries. This may lead to the scenario of a multi-speed EU with the core moving toward a form of federation.

IV. Cyprus' Adoption of the Euro and the Implications

Cyprus' adoption of the euro as of January 2008 is without doubt its most important achievement since accession to the EU in 2004. This development is expected in the longer run, to have far reaching economic, social and political implications.

The process of transition to the euro has been smooth without any significant obstacles. The government consistently pursued a prudent fiscal policy without upsetting social fundamentals and other parameters. This policy in conjunction with satisfactory GDP growth paved the way for nominal convergence with the Maastricht criteria. This was important but at the same time it must be acknowledged that much remains to be done for real convergence in the years ahead.

The benefits of euro adoption are of greater interest; these are classified into two main categories: a) the direct implications of monetary integration, and, b) the long-term adjustment processes set in motion for real convergence.

The improvement in the macroeconomic framework generates the conditions necessary for attracting added foreign direct investments and for encouraging domestic investments. These new trends in turn provide added stimulus to economic activity and help improve productivity levels raising at the same time the consumption possibilities of the country.

For Cyprus the adoption of the euro is an important milestone for another specific reason. As the country tries to achieve real convergence with the EU it will also have to rise to the challenge of reunification. At the same time a number of issues that were raised by the Turkish Cypriot side during the negotiations that led to the Annan Plan of 2004, more importantly the objective for separate central banks and a neutral currency in the federal state, other than the Cyprus pound, have been eliminated *a priori* after the introduction of the euro.

The euro has the potential to be a unifying tool in Cyprus, not only economically but also socially and politically. The euro calls for a more unified economic and political structure in the case of a solution. This has clear implications: if a unified Cyprus is to meet its obligations as a member of the EMU it must follow uniform and consistent economic policies. This requires coordination and cooperation. The risks of instability as a result of fiscal pressures consequent upon solution and re-unification without the euro are now being eliminated.

All these issues must receive their fair share of attention by the political and business leaders of both communities in Cyprus. The euro can prove to be the catalyst for new thinking in relation to the reunification of Cyprus. In this regard it should be noted that in federal arrangements it is of utmost importance to advance a common value system, common objectives and common institutions. The euro serves these objectives in direct and indirect ways. At the same time the euro entails responsibilities in relation to fiscal prudence and also raises the issue of a broader economic policy coordination. In sum, Cyprus adoption of the euro also influences the type of the solution of the Cyprus question: the reunification of this island-state presupposes an integrated society, economy and political structure.

In this regard perhaps it is important to consider the possibility of a paradigm shift: from the bizonal bicommunal federal model in which power is essentially concentrated in two constituent states to a model of functional federation in which power derives basically from the central government. Within the framework of this discussion it is also essential to acknowledge that the functional federal model entails an integrationalist approach and also allows the market forces to play an important role. For this scenario to materialize though the consent of the Turkish(Cypriot) side is important.

VI. Concluding Remarks and Suggestions for Further Research

The introduction of the euro has had far reaching implications in the countries that have adopted it and in the international monetary system generally. The EMU is a unique endeavour in monetary history in the sense that it is the only case of monetary union with a common currency and a common central bank but without a comprehensive political union. It is today the most advanced form of economic integration and poses many advantages for its members. The creation of truly integrated capital markets and the introduction of the single currency have meant the virtual elimination of currency crises for its members. The euro has created a nominal policy anchor necessary for macroeconomic stability which has been more supportive for trade, investment and ultimately economic growth. The reduction of transaction costs and the absence of exchange rate volatility across the countries of the Eurozone have greatly enhanced trade and productivity.

At the same time in terms of political repercussions, the introduction of the euro constitutes an act of transfer of competence and, indeed, power from the national level to a supra-national structure. Given that the adoption of the euro may also be symbolic of the further reduction of the sovereignty of the nation-state and the simultaneous further upgrading of the EU, it is only natural that there may be higher expectations from the Union.

But the euro is only ten years old and has not really been tested in a protracted low growth environment. Low growth or variable growth rates across member countries heighten fiscal imbalances making a common monetary policy more controversial as the specific needs of individual countries begin to diverge. Globalisation and intensified competition means that real growth patterns in the EU are changing.

Fiscal federalism can offset the effects of asymmetric shocks and consequently can play an important and complementary role to monetary policy. Government finances at the national level are coming under severe strain as a result of a number of factors: the ageing of the population, rising medical costs and rising demand for public services in general. Lack of coordination of national fiscal policies raises a singular threat to the single currency. Hence, the development of fiscal federal arrangements may be of great importance to the functioning of the EMU. However, fiscal federalism will be most difficult to achieve outside a distinct process for political unity.

In the financial sphere, in order to enhance the stability of the system in the EMU it might also be necessary to shift some elements of supervision at least, to the supranational level. The EMU is an integrated capital market but regulation is in the hands of national authorities which limits the ability to provide preventive supervision.

For small open economies like Cyprus, for which monetary policy independence and exchange rate autonomy may not be adequate to weather the consequences of adverse exogenous shocks, the introduction of the euro has been particularly beneficial. Cyprus' adoption of the euro is without doubt the most important achievement since accession to the EU in 2004. It has been accompanied by lower interest rates, reduced inflation, higher investment rates and accelerated growth. Per capita income in purchasing parity terms has risen to almost 90 per cent of the EU average. This coupled with considerable progress toward real convergence reduces the possibility of adverse exogenous shocks from being destabilising.

At the same time the euro has the potential to be a truly unifying tool in Cyprus socially and politically as well. A number of contentious issues in the negotiation process that preceded accession are being settled by virtue of the fact that the euro will be the common currency of a potentially reunified country. The euro also has important implications for the economic and political structure in the case of a solution. In order to meet the requirements of EMU membership and of the stability and growth pact a high level of cooperation and coordination will be required at all levels. In essence, introduction of the euro and participation in the Eurozone may require a paradigm shift from the discussion of a loose bizonal bicommunal federation to an integrationalist functional federal model.

Undoubtedly, the issues raised are many and multidimensional, and more research on the several specific topics is certainly warranted. Some of these topics would be EU budgets, how to address socio-economic problems not only in particular countries but also on a regional level, and a study of the further evolution of the euro and the repercussions on the concept of European identity.

Last but not least it should be stressed that much more systematic research is required in relation to the EMU and the political, social and economic repercussions and implications for the member states and the EU as a whole. In the case of Cyprus it also seems that the adoption of the euro and participation of this country in the Eurozone has far-reaching political implications. These issues deserve further analytical examination.