Working Paper
Research Division EU/Europe
Stiftung Wissenschaft und Politik
German Institute for International
and Security Affairs

*Ognian Hishow, Miguel Otero-Iglesias,
Federico Steinberg, Paweł Tokarski (ed.)*

The Euro Paradox: Explaining the Resilience of the Single Currency

SWP Working Papers are online publications within the purview of the respective Research Division. Unlike SWP Research Papers and SWP Comments they are not reviewed by the Institute.

Ludwigkirchplatz 3- 4
10719 Berlin
Phone +49 30 880 07-0
Fax +49 30 880 07-100
www.swp-berlin.org
swp@swp-berlin.org

Working Paper RD EU/Europa, 2018/Nr. 01, January 2018
SWP Berlin

Content

List of Figures

List of Tables

Introduction

The main aim of this paper is to explain a paradox. There is a broad range of literature in economics stating that the Eurozone is an unsustainable construct that is far from being an Optimum Currency Area, or even a sustainable entity. It lacks macroeconomic convergence and enjoys limited capital and labor mobility. However, despite the numerous negative assessments, the common currency still exists. What is more, it enjoys the strong support of governments and civil societies in Europe. This may be surprising in light of the severe pain of fiscal consolidations the Southern members have had to endure. Countries such as Greece, Italy, Ireland, Cyprus, Spain, and Portugal have had to bear the tremendous social costs of budgetary cuts. In these countries, there has been harsh criticism of how the Eurozone crisis was managed. On the other side, there is the feeling among the populations in the North that "they" have to pay for the "reckless" behavior of the Southern countries.

This working paper attempts to look for an explanation for this paradox: Despite not fulfilling the economic criteria, why does the Eurozone still exist, and why does it enjoy strong support in European societies? This paper consists of four different contributions. The first two explore the main flaws of the Economic and Monetary Union (EMU) from economic- and political-economy perspectives. The other two analyses explore the reasons behind the high levels of support for the euro currency in the Southern and Northern Eurozone countries.

The first contribution, by Ognian Hishow, examines the questions of why the euro fell short of expectations and what its main flaws are. What were the reasons for the divergences between the North and the South of the euro area? This section concludes that the origins of the currency union's flaws must take into account various inflation developments and differences in the current account balances of individual countries. The author stresses the positive effects of fiscal consolidation, which can lead to a rebalancing of the currency union without the necessity of further fiscal integration.

Miguel Otero-Iglesias' examination of the political motives for currency integration comes to a different conclusion: The main challenge for the future of the EMU is its unfinished institutional character. Building upon a Chartalist theory of money, he argues that the primary fault in EMU integration is the lack of a political entity behind it. Therefore, political integration is the necessary condition for the survival of the common currency, as the euro area in its current form is not prepared to withstand another crisis.

Using a historical-constructivist approach, Federico Steinberg examines in his text the reasons for the great support for the euro in Southern Europe. To understand this phenomenon, it is necessary to review the historical experiences of individual countries, in which European integration played, indeed, a very positive role in the democratization process. In Greece, Portugal, and Spain, European integration and the euro currency are considered modernity factors. However, this group of states is not homogeneous, and the perception of the euro in Italy currently differs from the other members of the group.

The last contribution, by Paweł Tokarski, makes an attempt to explain the "Euro paradox" from the point of view of the Northern members of the EMU. This group has a clear leader, Germany, which not only dominates the decision-making process but has also benefited from the euro in the most significant way. The reasons behind the support for the euro among the Northern countries are dominated by economic arguments. However, there are also other reasons. For the Baltic states, for example, geopolitical calculations play an important role.

The different views and perspectives applied in this working paper are aimed toward contributing additional value to the ongoing – even accelerating – debate about the future of the euro.

Economic Requirements for Rebalancing Non-optimum Currency Areas

Ognian Hishow

Why the euro fell short of expectations – what were the main flaws?

The crisis of the euro area proved that the common currency is driving a wedge between the participating member states – best manifested in the competitiveness gap between the more productive "North" and the less competitive "South."

The economics of a common currency area require all member states to stay competitive relative to the partners. Since the euro area is not an Optimum Currency Area, member states that lost competitiveness must regain it on their own. Nominal currency devaluations are impossible; what is left in the short run are cost and spending cuts, that is, internal devaluation. Competitiveness is gauged by shifts in the real exchange rate, which are captured in the current account balance. Here, the downside – the current account deficit – matters the most because accumulated current account deficits cause the net international investment position (NIIP) to deteriorate. Unsustainable negative NIIP reflects too heavy a foreign debt service burden and may cut off a nation from the financial markets (sudden stops occur). Put differently, soaring net imports are going to make the foreign debt-to-GDP ratio unsustainable. That is what happened around 2010 in Greece, Portugal, and Cyprus – and partly in Spain and Italy – in the South. In the North of the euro area, the Baltic states and Slovakia (as well as Bulgaria, whose currency sports a hard peg to the euro) were also running unsustainable current account deficits in the "roaring 2000s." Large current account deficits mean that the amount of money in circulation is declining, and given the sudden stops and absence of fiscal federalism, the shrinking money supply requires the price level to fall (the effect is known as Hume's Mechanism). There is a debate about which one is dominant: the current or the capital account. Some point out that the capital account (inflow of money) was the trigger of the imbalances. However, according to Hume, it is always the deficit side that must take action to return to competitiveness. Market forces impose disinflation and even deflation – that is, internal (also known as "real") devaluation (sometimes fiscal devaluation) – on the country in question. The purpose of internal devaluation is to close the competitiveness gap by means of lower export prices. In the short run, this is accomplished mostly through simple cost reductions, foremost through wage cuts or layoffs throughout the entire economy. (In the long run, innovations and technological advances can make an economy more productive, and thus more competitive.) The important question here is why competitiveness in the

European currency union diverged. The answer is: In the 2000s, the euro area member states had varying inflation rates. In the catch-up countries on the Southern periphery of the euro area, they typically were higher than in the mature economies of the North. In the end, the inflation differentials are to blame for the subsequent austerity policies those countries were forced to introduce. In the member states with higher inflation rates, real currency appreciation took place. This spurred imports and impeded a matching growth in exports, creating the abovementioned (large) current account deficits and an excruciating foreign debt service burden. In the face of the inability of those countries to service their foreign debt, the private capital markets imposed sudden stops, which, in effect, started to (painfully) push those countries toward rebalancing.

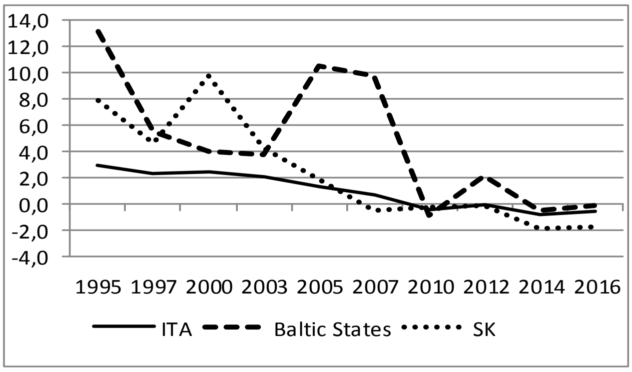
What went right despite the euro area not being an Optimum Currency Area, and what are the lessons learned?

At first glance, it is a paradox that austerity is pro-integrative in the euro area (angry street protests would indicate the opposite). Yet, in spite of being socially difficult, austerity pushes countries toward competitiveness. Another conclusion is that returning to balance requires focusing on the current account position. Focusing mainly on the budget balance is rather misleading. For example, Germany was criticized for its high budget deficit in the early 2000s (higher than the permitted 3 percent of GDP), and Belgium's public debt ratio always remained way above the Maastricht level of 60 percent of GDP. At the same time, the budget and public debt positions of most of the countries in crisis – Portugal, Cyprus, Spain, the three Baltic states, Bulgaria, and others – were good, or even excellent. Yet, the markets never imposed sanctions on Germany or Belgium because they were (and still are) running significant current account surpluses. In contrast, they punished most Southern member states with salient budget positions, as it became obvious that they were being destabilized by large and persistent net imports.

The crucial requirement for returning to growth and employment, that is, regaining competitiveness, is to get the major indicators right that capture the competitiveness positions of the member states in crisis. Two indicators – the inflation rate and the current account balance – stand out and were central in the efforts of the euro area member states in crisis to rebalance. Those countries can be organized into two groups. One group is made up of countries that returned to balance on their own: Italy, the Baltic states, and Slovakia. The other group is comprised of euro area member states under a current, or phased out, financial aid program: Cyprus, Greece, Ireland, Portugal, and Spain.

The inflation rate directly affects the real exchange rate, and therefore the competitiveness position. In an open economy, inflation and the nominal exchange rate are linked together. That implies that in the euro area, where shifts in the nominal exchange rate are not possible, inflation differentials between the participating economies must disappear. Put differently, once they emerged, market forces start exerting pressure to eliminate them. The countries without bailout programs reviewed here – Italy, the Baltic states, and Slovakia – achieved that on their own, that is, without supervision by international actors, notably the so-called Troika (later re-labelled to "Institutions"). Around 2007–2008 they engaged in disinflation, even in deflation, in order to make up for the – in some cases very large – inflation differentials to Germany they had built up. From about 2010 (somewhat later in the Baltic region), their inflation rates have been below those of Germany, the benchmark country (see Figure 1).

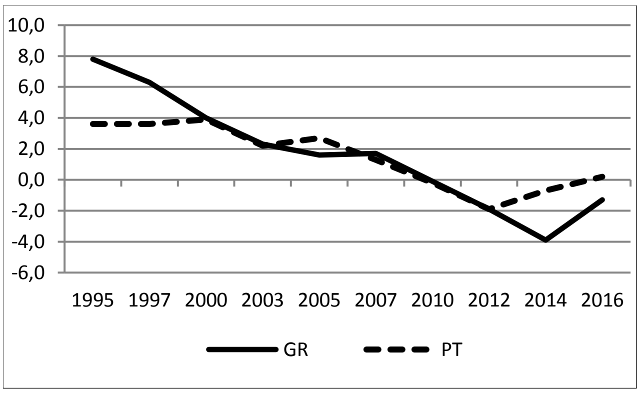
Figure 1
Inflation differentials to Germany (price deflator GDP), in percent; countries without sudden stop

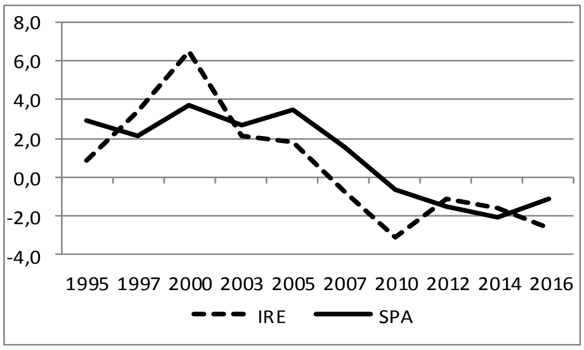


Source: Eurostat

The countries with a rescue program – and most prominently Greece and Portugal – display an even more palpable trajectory of price-level realignment, as the theory predicts. Their huge inflation differentials to Germany's levels started to disappear when it became obvious that there would not be enough money to maintain the hitherto level of income. Wages, and therefore the overall price level fell (more pronounced in Greece, the country with the greatest need for rebalancing), and the inflation differential has remained negative since around 2010–2011 (Figure 2a).

Figure 2a and 2b
Inflation differentials to Germany (price deflator GDP), in percent; countries with bailout program





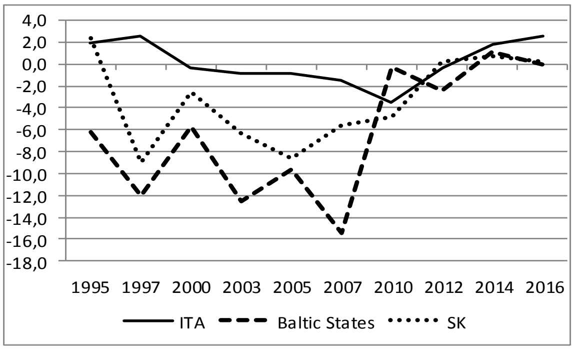
Source: Eurostat

In Spain, too, the crisis imposed austerity measures in the form of layoffs, and thus pressure was put on wages from roughly the late 2000s onward. Inflation differentials to Germany's value began to diminish and have remained negative since 2010. Ireland is somewhat different, as the process of overcoming the imbalances of the "roaring 2000s" has been underway for a longer period, from about the early 2000s (see Figure 2b). The reason probably had to do with growing current account deficits resulting from fast-growing wages in the period before. To sum up, in line with the theory, under the circumstances of a lacking fiscal federalism in the euro area, realignment by means of cost reductions was needed. This is what really happened in the countries that were most severely hit by the crisis, albeit with variations from member state to member state.

The analysis thus far has centered on the assumption that members of a currency union that have lost competitiveness are being pushed by market forces to regain it. To assess how competitive an open economy with a fixed nominal exchange rate is, markets would first look at the foreign debt service burden. Hereby, it is helpful to look at the **current account balance**; as stated above, a string of current account deficits indicates that the competitiveness position is deteriorating, and the accumulated foreign debt is becoming too large to be serviced with certainty. However, a worsening current account balance (permanent unsustainable deficits) is just the result of occurrences that have preceded its deterioration, most notably higher inflation rates. They can be the result of soaring unit labor costs, that is, productivity trailed nominal compensation. As already concluded, most of the euro area member states in crisis went through a period of deterioration of the current account (roughly between 1995 and 2010), followed by a period of improvement from 2010 up to now. This has reopened their access to the financial market. In the case of Greece, the hope is that access is imminent, that is, more aid programs using public money will not be needed.

The theoretical prediction fits well into the real record of all euro area member states examined here. Their current account curve is clearly V-shaped. After starting off with (in some cases substantial) current account deficits in the 1990s and early 2000s, a reversal of the trend was achieved afterwards. This can be attributed both to the pressures of the market and the initiated measures of structural adjustments and cost savings across the whole economy. Figures 3, 4a, and 4b offer a convincing impression of the results.

Figure 3
Current account deficits in percentage of GDP; countries without sudden stop



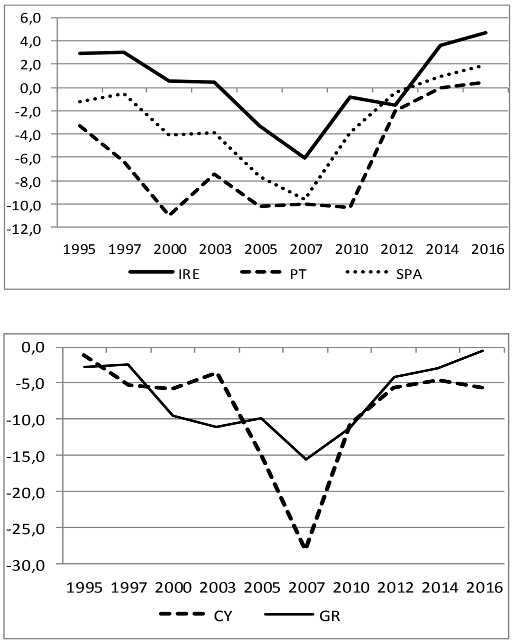
Source: Eurostat

Among the countries that managed turnarounds on their own were the Baltic states. These countries were reporting enormous current account deficits in the "roaring 2000s." However, in the Baltic states as well as in Slovakia and Italy, the deficits developed into surpluses or insignificant deficits (less than the nominal GDP growth rate) in the matter of a few years.

Ireland, Portugal, and Spain succeeded, too, with the Irish and Spanish current account curves forming solid V-shapes (Figure 4a). Ireland's recovery was supported by its competitive export sector; in 2013, the country exited the bailout program it had been in for three years. In Ireland the previous deterioration of the net international investment position might have been caused by valuation effects: Foreign direct investments denominated in dollars lost value when the euro strengthened in the mid-2000s. As a reaction, markets exerted pressure to improve the Irish net international investment position.

However, the most spectacular U-turn is probably Greece, which was, until recently, a "lost case" for many, as it was unable to cope with the requirements of membership in the euro area. As Figure 4b suggests, the Greek current account position almost perfectly fits the theoretical prediction that – under the pressures of the market – net imports will turn into net exports once the respective country has lost access to the financial markets. If no further disruptions occur, Athens is expected to report a current account surplus next year. Basically, the same applies to Cyprus, with the caveat that the Mediterranean island is still "under water," that is, it is still running deficits, even though they are smaller. Whether this is the effect of a foreign investment influx or the process of a restructuring that is not yet complete still has to be determined. A vestige of uncertainty remains, therefore, right up to the possibility of another breakdown, if the ongoing deficits prove to be unsustainable.[1]

Figure 4a and 4b
Current account deficits in percentage of GDP; countries under bailout



Source: Eurostat

In the process, a fierce theoretical discussion erupted in academic circles about whether a return to balance through cost and spending cuts during a recession is ever possible. It was another paradox of the common currency (yet backed by empirical evidence) that crises are not only a social affliction but that, in this case, they also helped to conduct a Schumpeterian "creative destruction" and bring the euro area back to strength. The ultimate measure for being or not being competitive is the current account balance. Ideally, an open economy must pay for its imports out of the generated export revenues. This means that, in the long run, the current account balance should be close to zero. This ensures that an unsustainable stock of foreign liabilities is avoided.

In the euro area, the long-term records (20 years) of all countries in trouble prove that the assumption is right: namely, that rebalancing is possible. In the euro area, Germany and a few other "Northern" member states have remained competitive, whereas others – determined not to give up the common currency – undertook efforts to regain competitiveness. The wild card has been Greece, which, at the height of its dispute with the Troika, even conducted a referendum on its compliance with the bailout conditions. Against this backdrop, the good news is that, even in this most

1 Current account deficits are regarded as unsustainable when the debt service – in percentage of GDP – becomes greater than the nominal GDP growth rate.

severe case, the efforts of Athens and the aid of the Institutions have finally begun to push the Greek economy in the right direction. The other countries considered here fit well within the same pattern. One undisputed conclusion is that rebalancing the economy through internal – or real – devaluation comes with high social and economic costs. The final conclusion is that the prerequisite for a functioning common currency area is to allow market forces to work, in contrast with calls for redistribution – right up to establishing a fiscal union – in Europe.

Explaining the Resilience of the Euro: What the Political Economy Says

Miguel Otero-Iglesias

The euro crisis has spread the belief that the creation of the EMU was a big mistake. Seen in hindsight, it is difficult to understand why weak Mediterranean economies such as Greece, Italy, Portugal, and Spain dared to give up their monetary sovereignty and lock themselves into a fixed exchange-rate regime with super competitive Germany. It is often mentioned that the euro is the product of economically illiterate politicians who naively thought they could construct the United States of Europe by creating an artificial currency.[1]

Political motives for currency integration?

There is some truth in this, but the construction of the EMU is more complex. It is important to understand why the euro was created in the first place. The utopian idea of one money for Europe started to take shape at the end of the 1960s, when the United States began to accumulate huge trade deficits with the European countries, and it decided to default by closing the gold window, ending the Bretton Woods system and sending the dollar into a nosedive. It is no coincidence that the *Werner Report* on the creation of the EMU was published in 1970. Since this moment, the Europeans have been confronted with what is referred to as "dollar shocks." The United States has typically used these shocks to its advantage, and this is why the international political economy literature has labeled it the "dollar weapon." In the 1970s and 1980s, the Europeans and Japanese suffered due to the dollar weapon on numerous occasions. Whenever the US current account deficit was too large, Washington activated its monetary statecraft to force an adjustment. This was done by running an expansionary fiscal policy and, thus, exporting inflation; by "talking down" the dollar; by forming diplomatic coalitions (especially with France) to force the surplus countries (Germany, in particular) to reflate their economies; or, if the above did not work, the United States would even threaten to withdraw its troops from Germany and Japan if they did not appreciate their currencies.[2]

Hence, there were two external reasons for the creation of the euro: the collapse of Bretton Woods and the dollar weapon. These external factors triggered internal ones. The European countries are small and open

[1] Lars Jonung and Eoin Drea, "The Euro: It Can't Happen. It's a Bad Idea. It Won't Last: US Economists on the EMU, 1989–2002", Economic Papers No. 395 (European Commission, 2009).

[2] Randall Henning, "Systemic Conflict and Regional Monetary Integration: The Case of Europe," *International Organization* 52, no. 3 (1998): 537–73.

economies that trade a lot with each other. This is the reason why, historically, they have always preferred fixed exchange rates.[3] In the 1970s, they created the "snake in the tunnel," and in the 1980s the European Monetary System, but by the globalized 1990s, they realized that they were facing the "impossible trinity" in international economics. However, instead of embracing free capital flows, an independent monetary policy, and floating exchange rates – like the United States and the United Kingdom did – the Europeans came up with an ingenious idea. With the creation of the euro, they could overcome the "trilemma." Internationally, they would create a single monetary platform robust enough to face new dollar shocks. This resilience would allow them to have free capital flows, a floating euro, and a European Central Bank (ECB) with its own independent monetary policy. Meanwhile, with the EMU, internally the Europeans would have fixed exchange rates and free capital flows, which necessarily implied losing national monetary autonomy. This was not a big deal for most of the weaker countries, because Europe was – since the inflationary dollar shock of the 1970s – already operating in a de facto deutsche mark zone, dominated by the hawkish, stability-enforcing Bundesbank.[4]

This brings us to the political economy behind the bargaining that led to the euro. France wanted a monetary union because in the 1980s it had already lost its monetary sovereignty to the global financial markets and the Bundesbank. The fall of the Berlin Wall in 1989 provided a unique window of opportunity. François Mitterrand was smart enough to take it and made an offer to Helmut Kohl: French support for German unification in exchange for monetary union. The majority of the Germans were skeptical – especially the Bundesbank – about the idea of creating a monetary union without a political union, but the prize of German reunion was just too big to reject.

What went wrong? Unfinished business in the EMU architecture?

The creation of the EMU was therefore the consequence of multiple factors, compromises, and misconceptions. The biggest misconception of all was to disregard the ontology of money. Although mainstream economists have only one explanation for the origin of money, the fact is that, historically, there have been two ways to understand the nature of money.[5] The first is represented by the orthodox – also called metallist – school of money (this is the one described in standard economics textbooks), which believes that money emerged spontaneously from the market to overcome the problems of the double coincidence of wants of barter. The Optimum

[3] Tommaso Padoa-Schioppa, "The Ghost of Bancor: The Economic Crisis and Global Monetary Disorder", *Louvain-la-Neuve*, 25 February 2010, retrieved from http://www.institutdelors.eu/media/speech-tps-louvainlaneuve-25.02.2010.pdf?pdf=ok.
[4] David Marsh, *The Euro: The Politics of the New Global Currency* (New Haven: Yale University Press, 2009).
[5] Charles Goodhart, "The Two Concepts of Money: Implications for the Analysis of Optimal Currency Areas", *European Journal of Political Economy* 14, no. 3 (1998): 407–32.

Currency Area theory builds on this tradition. It applies the logic of the metallist school of money on the spatial dimension. It argues that a single currency can reduce transaction costs in areas with high degrees of mobility in their factors of production. Thus, in its pure logic, the Optimum Currency Area theory says that a big nation state such as Russia could have several currencies, and that several integrated states, such as the Benelux countries, could share one currency. This de-politicization of money is crucial to understand why, in the 1990s, the official mantra from the European Commission was that the euro would provide "one money for one market." Under this logic, money is a neutral device, and therefore credit relations – and their inherent social power struggles – are overlooked.

There is, however, another view on money represented by the more heterodox Chartalist school of money, which claims that the most important function of money is not to be the medium of exchange, but rather the unit of account, which has – since pre-historic times – always emanated from the taxing scale imposed (through persuasion or coercion) by the sovereign on its subjects in any given monetary space. Following this interpretation, money, which is always debt, cannot exist without a centralized and legitimized political authority, which functions as the mediator between creditors and debtors, and provides the arena (in modern times Parliaments) in which their tensions are resolved.[6] If we accept this heterodox conception of money – which by now has been embraced by some of the executive members of the ECB[7] – then the euro is an orphan currency without a sovereign, and this is the reason why it is still so exposed to speculative attacks by financial market operators and dollar shocks. When the euro was created, Germany was inclined to build a political union to make it more robust, but France was against this. So the compromise was to create an EMU based on a strongly orthodox framework (the Maastricht Treaty). This would convince market operators that this was a strong currency with a fiercely independent ECB, which would never allow the monetization of debt – historically the nightmare scenario of international creditors.[8] Not being able to create a European sovereign, France and Germany agreed to establish a system with many rules but little political discretion. This de-politicization was seen during the first decade as being positive, but the Eurozone debt crisis has shown that it is a source of instability, with the conceptual corollary being that the Optimum Currency Area theory has serious shortcomings in understanding the political economy of credit relations in the EMU.[9]

[6] Geoffrey Ingham, *The Nature of Money* (Cambridge: Polity, 2004), 25.
[7] Benoit Coeuré, "Sovereign Debt in the Euro Area: Too Safe or Too Risky?" (Cambridge, MA: Harvard University, 2016), retrieved from http://www.ecb.europa.eu/press/key/date/2016/html/sp161103.en.html.
[8] Ingham, *The Nature of Money*, see note 6.
[9] Miguel Otero-Iglesias, "Stateless Euro: The Euro Crisis and the Revenge of the Chartalist Theory of Money", *Journal of Common Market Studies* 53, no. 2 (2015): 349–64.

Different visions of economic policy and the rise of populism

From 2010 until 2012, market operators were continuously asking: What is the political authority behind the EMU? Although this question remained unanswered, betting on the collapse of the euro was logical. The situation only stabilized in June and July of 2012, when Chancellor Angela Merkel spoke openly about political union when she agreed to establish a banking union, and, crucially, when Mario Draghi stated that the ECB would do "whatever it takes" to save the euro – and even more decisively, when Merkel threw her political weight (and consequently that of the German taxpayers) behind those words the day after. But Merkel is the legitimate political leader of the German population, not that of the Eurozone as a whole. This creates enormous tensions – as last seen in the summer of 2015, when Greece depended on Merkel's will to stay in the Eurozone. No wonder the European Commission has since consolidated its view: that the monetary union needs to be completed with an economic and political union, equipped with a sizable Eurozone treasury that can deal with asymmetric shocks and issue a risk-free European sovereign bond that can function as the anchor of the newly created banking union.[10] Only then would the EMU step beyond economy orthodoxy and become an institutionally and politically embedded monetary union with a chance to survive.[11]

However, despite multiple calls to deepen the EMU, the truth is that, since the ECB stopped the convertibility fears of 2012, the reform process has stalled. The banking union is built on a joint supervision mechanism and a common resolution fund, but due to the resistance of the Northern countries to mutualize past legacy debt, it lacks a European deposit insurance scheme. Furthermore, there have not been any advances in creating a genuine fiscal backstop, and no progress at all in issuing joint Eurobonds, as demanded by the Southern countries. Overall, the Eurozone governance structure is still based on the Stability and Growth Pact (reinforced by the "six-" and "two-pack"), which does not offer the European Commission – nor the Eurogroup for that matter – sufficient legitimacy and capacity to change the macroeconomic policies of the member states. Thus, the reality is that the Eurozone remains a monetary union that lacks a fiscal and political union. This muddling-through strategy has convinced many that the EMU is not prepared to withstand another big shock, and hence it is likely that it will lose some of its member states in the next decade.[12] Apart from Greece, concerns are focused now on Italy, a founding member of the EU mired in economic stagnation and with a very large public debt overhang (the third biggest in the world, in volume terms,

[10] European Commission, "Reflection Paper on the Deepening of the Economic and Monetary Union" (Brussels, 31 May 2017).

[11] Kathleen McNamara, "The Forgotten Problem of Embeddedness: History Lessons for the Euro", in Matthias Matthijs and Mark Blyth (ed.), *The Future of the Euro* (Oxford: Oxford University Press, 2015).

[12] Joseph E. Stiglitz, *The Euro: How a Common Currency Threatens the Future of Europe* (New York: W.W. Norton, 2016).

after the United States and Japan). There is also the possibility that support for the euro might vanish in Germany, the backbone of the monetary union. The German population has always feared that the creation of the single currency would lead to a transfer union. Many believe that Mario Draghi's near-zero interest rate policy and quantitative easing program are attempts to achieve it through a monetary subterfuge. The ascendancy of the *Alternative für Deutschland* party (although its appeal is receding) and the more recent ascent of the neo-liberal Free Democratic Party (FDP) can partly be explained by this sentiment.

Factors that can explain the resilience of the euro

However, despite Europe's multiple crises and the rise of Euroskepticism, support for the single currency within the Eurozone has remained high – near 70 percent over the past 10 years, according to Eurobarometer (see the next two contributions). In contrast, in EU states outside the Eurozone, support for the euro declined over the same period, from 56 percent to 37 percent – a clear sign that people within and outside the EMU perceive the euro differently. What explains this? Some of the Eurozone's support for the single currency comes from fear of the consequences of abandoning it. Debtor states such as Italy would have their credit ratings downgraded if they left the currency union, raising the interest they would have to pay on new debt, making default nearly unavoidable. Furthermore, the devaluation brought about by reverting to the old currency would fail to stimulate domestic demand or boost exports, as creeping inflation triggered by higher import costs and wages would probably offset any gains in competitiveness. Quitting the euro would also require expensive legal and technical maneuvers: from introducing a new currency and re-denominating contracts in it to imposing capital controls. The result could be a massive financial crisis.[13] No wonder so many people in the Eurozone do not want to leave it. Yet the Eurozone's citizens also want to stay in the currency union because it offers them benefits. Despite the recession, many Europeans in the Southern Eurozone believe that the EU and the euro offer a measure of democratic stability that their national institutions cannot. In this region, most citizens appear to attribute their countries' economic problems to domestic sources, such as incompetent elites, weak education systems, and a lack of meritocracy and official transparency, rather than to the common currency itself. Although popular regard for EU institutions fell in the aftermath of the Eurozone crisis, trust in national institutions in the Southern Eurozone has fallen even lower. What is more, in states such as Greece, Portugal, and Spain, which transitioned to democracy relatively recently and suffer more from inequality and corruption than their Northern European peers do, the euro's requirements serve as a straitjacket on predatory domestic elites.

13 Barry Eichengreen, *The Breakup of the Euro Area*, NBER Working Paper No. 13393 (Cambridge, MA: September 2007).

Perhaps no feature of the euro appeals to people in the Southern Eurozone as much as its stability does. Before the euro's introduction, many citizens of the Mediterranean countries stashed much of their wealth in stable foreign denominations, such as the dollar and the deutsche mark, because they feared that fluctuations in the value of their own countries' currencies would undercut their savings. Yet, the euro's stability throughout the crisis has helped guarantee the savings of retirees, whereas older currencies could not. It has obviated business owners' concerns about devaluations, and it has enabled members of the middle class to have a strong currency when traveling abroad, just like their American and British peers. In the Northern Eurozone, too, citizens prize the stability that the single currency offers. Exporters there no longer need to fear that their Italian and French competitors might benefit from the devaluation of the lira or the franc. Middle-class tourists from countries such as Germany do not have to fret about currency conversion when traveling to Greece.

So citizens in the Northern and Southern Eurozone value the currency's stability for different reasons. But in both areas, they regard the euro as the most tangible symbol of European integration. In an uncertain world, stable money can be a powerful symbol of social trust and security. This is the reason why the Baltic countries joined the Eurozone. Faced with the Russian threat, they prefer to be inside the Eurozone. Indeed, currencies are not simply economic phenomena; they are also cultural ones, and they can help build common identities.[14] By acting as the medium for millions of daily exchanges, the euro has gradually become a shared code. Thus, the euro is "the only existent common language" in a union characterized by linguistic cacophony.[15] Eurozone citizens' experiences of economic crises in the years since 2009 have strengthened this bond, uniting them against what many felt were attacks by foreign speculators. People who use the euro are thus citizens of the EU in a way that differs from that of their peers outside the currency bloc. This explains why the Eurozone's outsiders often struggle to understand its insiders. The euro has been a kind of social glue, even though many Europeans disagree about the EU's management of the common currency. Indeed, research has found that parliamentary debates and media organizations covered similar agendas across Eurozone countries during the euro crisis – a sign that people throughout the currency bloc experienced economic traumas together. Confrontation is inherent to any political community, and even disagreements over euro policy can help construct bonds, since they help to Europeanize the public debate. The single currency has created tensions between Europe's South and North and its political left and right, but this is not necessarily a bad thing.[16] As explained above, the Eurozone needs to

[14] Eric Helleiner, "National Currencies and National Identities", *American Behavioral Scientist* 41, no. 10 (1998): 1409–36.

[15] Giovanni Moro (ed.), *The Single Currency and European Citizenship* (London: Bloomsbury Collections, 2013).

[16] Thomas Risse, *European Public Spheres: Politics Is Back* (Cambridge: Cambridge University Press, 2014).

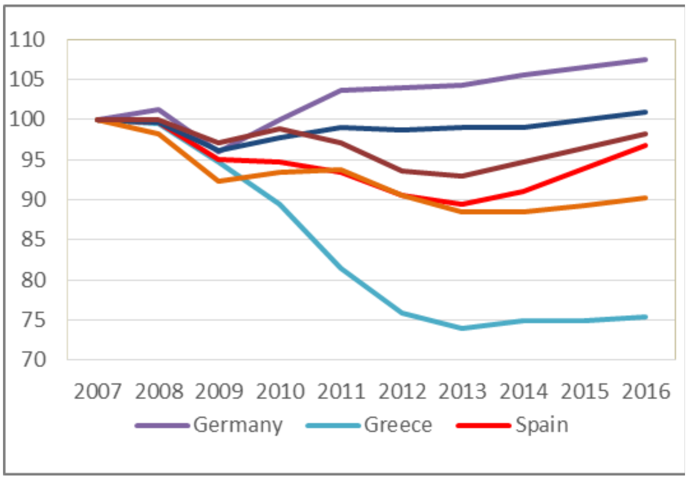
develop into a political union if it wants to survive (and political unions are not always rosy affairs). Europeans are not in love with the euro, but despite the proposals of populist challengers such as Marine Le Pen and Beppe Grillo, they do not want to get rid of it either. The impressive victory of Emmanuel Macron in the French presidential election epitomizes this sentiment. It is to be seen whether he will convince his German counterparts to create the Eurozone treasury and parliament that the EMU needs.

The Euro As “Modernity” – Explaining the High Levels of Support for the Euro in Southern Europe

Federico Steinberg

European integration has been going through major changes over the last decades. Many of these steps, including the establishment of the common currency, had severe economic consequences for its member states. For this reason, European integration, and its politicization, has always had close ties with the economy. This fact has led to the empowerment of many non-mainstream political parties in Europe, including the Euroskeptic ones, both from the left and right sides of the political spectrum. When we look at Southern European countries, we see that the criticism is mainly from the left-wing political parties targeting austerity policies. Even if this is the case, public support for the euro is almost always higher than the average of the European Union.

Figure 5
Evolution of per capita GDP in southern European countries and Germany, 2007–2016 (2007 = 100)



Source: Eurostat

Our argument is that the main reason behind the support for the euro – regardless of all the economic hardships these countries have been going through – has very much to do with historical perceptions of the European

Table 1
Percentage of Europeans in favor of a European Economic and Monetary Union with one single currency, the euro

	Nov-10	May-11	Nov-11	May-12	Nov-12	May-13	Nov-13	May-14	Nov-14	May-15	Nov-15	May-16	Nov-16	May-17
Spain	62	62	63	55	63	52	56	61	65	61	67	67	71	75
Greece	64	60	76	75	65	60	62	69	63	69	70	62	68	64
Portugal	56	49	54	58	54	52	50	59	58	62	67	69	74	74
Italy	68	67	57	53	57	59	53	54	54	59	55	54	53	58
EU-28	58	56	53	52	53	51	53	55	56	57	56	56	58	60

Source: European Commission, Public Opinion

Union. The main logic behind this claim is as follows: Since for most Southern European countries Europe means modernity, transition to democracy, and rising levels of prosperity – even if there is trouble and strong criticism regarding some of its policies – the overall perception of the Union (and the euro) remains positive. The following section goes through each country's story from a historical perspective, providing the facts related to the economic crisis. The next section then tries to justify the high levels of support for the euro, despite the negative economic realities that large segments of the population have experienced over the past years.

Understanding the support for the euro in Southern Europe

Southern Europe has recently gone through its worst economic crisis in decades. As Figure 5 shows, per capita GDP levels collapsed following the 2008 global financial crisis, leading to a "lost decade" that, in the case of Greece (and perhaps Italy), might even last longer.

However, despite the severity of the crisis, support for the euro has remained high. According to the latest Eurobarometer polls, 71 percent of Spaniards, 68 percent of Greeks, 74 percent of Portuguese, and finally 53 percent of Italians would like their countries to remain in the single currency. With the exception of Italy, euro support in these countries is higher than the EU average (see Table 1). In fact, as some authors show, support for the euro has remained high across the Eurozone throughout the crisis.[1]

This may appear shocking, given the depths of the double-dip recession and the incredibly high levels of unemployment, which dramatically affected both the younger generations and the long-term unemployed, especially in Spain and Greece. More importantly, given the perceptions among large groups within society – that austerity policies were largely a result of euro membership and that having an autonomous monetary policy could have allowed these countries to reduce the duration and intensity of the recession – one could have expected lower levels of support for the EMU. However, this has not been the case.

Following a historical-constructivist approach, we argue that one can only understand these high levels of euro support in Southern Europe by grasping the idea of Europe and the euro as *modernity*, which is an idea that is deeply entrenched in most Southern European societies, especially in Spain and Portugal.

In fact, constructivist international political economy emphasizes the importance that ideas and commonly shared values, as well as historical experiences, have in determining how individuals perceive their economic self-interests. As Abdelal puts it: "Constructivism is analytical language composed primarily of the social facts of the world, those facts that exist

[1] Felix Roth, Lars Jonung, and Felicitas Nowak-Lehmann, "Crisis and Public Support for the Euro, 1990–2014", *Journal of Common Market Studies* 54 (2016): 944–60.

only because they are collectively shared ideas. Such social facts influence patterns of political economy directly as socially constructed coordination devices; they also influence how agents interpret the material interest around them.”[2] Several authors have developed a constructivist approach to explaining the politics of money in general, and of the euro in particular.[3]

In order to understand the socially constructed perception of the euro that citizens in Southern Europe have, we need to look back into history and understand what Europe represents for Spaniards, Greeks, Portuguese, and Italians, both in symbolic and material terms.

Greece, Spain, and Portugal joined the EEC (European Economic Community) in the 1980s after long periods of dictatorial rule. These three countries, which arrived late to the industrialization process in the 20th century, and whose citizens were significantly poorer than the EEC average, experienced a rapid acceleration of economic growth before, and in the years following, ECC accession. Therefore, their citizens tend to associate the democratic consolidation of their countries with EU membership. The history of Italy, a signatory of the Treaty of Rome in 1957, is somehow different, and coincidently its levels of euro and EU support are also lower.

Differences within the group

Despite these similarities, each country has distinct characteristics. In Spain, EEC membership triggered a successful transformation of the Spanish economy. Generous and well-used European structural and cohesion funds helped to modernize Spanish infrastructure and accelerated the tertiarization of the economy, with a substantial incorporation of women into the labor force. Most citizens associate these trends with Europeanization. Greece and Portugal, however, did not see their income per capita levels converge with those of the EU-15 very quickly; in the case of Greece, its citizens never identified deeply with the European project. As Pagoulatos puts it, during the 1980s and 1990s, Spain, unlike Greece, was willing to let European policies influence its domestic economic and political dynamics due “to their extrovert ideological disposition, receptiveness towards developments in Western social democracy, ideational identification with Europe, and commitment to the European project.”[4] Greece, historically a more nationalistic and eastern-looking country that

[2] Rawi Abdelal, “Constructivism As an Approach to International Political Economy”, in Mark Blyth, *Handbook of International Political Economy*, pp. 57–71, esp. 63 (London: Routledge, 2009).

[3] Kathleen R. McNamara, *The Politics of Everyday Europe: Constructing Authority in the European Union* (Oxford: Oxford University Press, 2015); Miguel Otero-Iglesias, *The Euro, The Dollar and the Global Financial Crisis: Currency Challenges Seen from Emerging Markets* (Routledge, 2014); E. Helleiner, “Below the State: Micro-Level Monetary Power”, in D. Andrews (ed.), *International Monetary Power* (Ithaca, NY: Cornell University Press, 2006).

[4] George Pagoulatos, “Believing in National Exceptionalism: Ideas and Economic Divergence in Southern Europe”, *West European Politics* 27, no. 1 (2004): 45–70, esp. 57.

had been much less influenced by Western European narratives, embraced the EU with less intensity than Spain and Portugal.

It was precisely within this context that the euro was launched. For the Spanish and Portuguese national projects, going back to the heart of Europe required joining the euro from phase I, in 1999. Therefore, successive governments made enormous efforts to comply with the Maastricht criteria during the mid- and late 1990s … and they succeed (Greece joined two years later, in 2001). Interestingly, despite the significant efforts to reduce budget deficits in order to comply with the 3 percent deficit/GDP requirement, there was virtually no opposition to privatizations and/or budgetary cuts. With the exception of small political parties – mostly linked to the former communist party or to the extreme right in Greece – all relevant political and social actors believed that joining the euro was a first-order national priority that would require short-term sacrifices but would pay off economically and politically in the long run.

In Italy, however, things had been different. The country has been at the core of the European project from the start, did not experience an authoritarian regime after World War Two, and its citizens, therefore, do not seem to associate modernization and prosperity with the European project in such a direct way. As a result, Euroskepticism is more widespread.

Macroeconomic figures helped to reinforce the narrative that identifies the euro with stability and prosperity. Spain, Greece, and Portugal experienced rapid economic growth during the first decade of the euro, whereas Italy's performance was more disappointing. Obviously, euro membership, which generated lower financing costs that would later result in deep macroeconomic imbalances, was one of the growth engines of the period. In any case, this long period of rising prosperity cemented the perception that the euro was the key symbol of Europeanization, prosperity, and political relevance, especially in Spain. As a result, the socially constructed reality based on the idea that the euro has been unconditionally positive and that leaving it would be disastrous – as it would imply abandoning Europe, prosperity, modernity, and relevance at the international level – is perhaps stronger in Spain than in any other EU country.

In fact, when comparing Spain with other Mediterranean countries that might also share this idea of "the euro as modernity," there are some objective reasons why Spanish support for the euro is higher. First, during the first decade of the euro, no other country (except Ireland) did better in macroeconomic terms than Spain (Italy's GDP stagnated, Portugal's did not grown spectacularly, and Greece grew while accumulating unsustainable disequilibria). Second, during the crisis and post-crisis period, the collapse of Spanish GDP, while significant, has not been as severe as that of Greece and Portugal, and the recovery has been much faster. More importantly, the idea that Spain was able to avoid a full bailout program and that its economy could successfully be reformed within the EMU is shared by a large majority of the electorate, even by groups that seriously contest the usefulness of austerity policies. As a result, electoral support for the euro-critical party Podemos seems to have a ceiling of around 20 percent, and even this party is very careful in its messages: Unlike the M5S in Italy or the National Front in France, they are anti-austerity but pro-euro. Nevertheless, despite lower levels of support for the euro in Italy, it is unclear if a majority of Italians would prefer to exit the EMU. As Otero-Iglesias argues: “Many Italians don’t like the euro, the EU and Germany, but their trust in their national politicians and institutions is even lower. They reckon: ‘since the crisis started we were not able to produce a stable government, how will we be able to produce a stable currency?’ So, deep down they don’t want to leave because they do not know where to go.”[5]

To conclude, the euro and EU membership are regarded in Southern Europe as anchors of political (and even economic) stability. Even though there are many debates about what are the necessary reforms that Spain, Portugal, Italy, and Greece have to undertake to increase their potential growth and raise their productivity levels, few would argue that euro membership hampers those reforms. Business, trade unions, and civil society at large have different views about the distributional consequences of these reforms, but none of them would argue that, without the constraints imposed by euro membership, reforms would be better designed or implemented. The high levels of perceived corruption in these countries make most citizens afraid of eliminating the anchoring to transparency and rigor that EU membership provides. This is not the case for more consolidated democracies such as the United Kingdom, Denmark, or even France, where citizens tend to have higher levels of trust in domestic institutions and politicians. In Italy, however, where the last 20 years have not delivered substantial economic gains, and where the domestic narrative does not link progress and modernity with Europeanization so clearly, support for the euro remains at worryingly low levels.

[5] Miguel Otero-Iglesias, “Italy’s Struggle with the Euro Straitjacket”, *LSEblog* (2017), retrieved from https://european.economicblogs.org/lse/2017/blogadmin-italys-euro-straitjacket.

Explaining Support for the Common Currency in the Northern Euro Area Members

Paweł Tokarski

The countries that can be classified as the North of the euro area[1] share a common interest in maintaining the common currency, mainly due to benefits of both a political and economic nature, and out of fear of the negative consequences of disintegration. However, the prioritization of arguments is different in each country and are based on different sizes and geographical locations as well as different economic and social models and levels of economic development. The members of this group also have diverse internal economic, social, and political challenges.

The controversies surrounding the financial assistance for the Southern Eurozone members were an important factor in generating support for

Table 2

Support for the euro in the Northern Eurozone member states (%)

	nov-10	may-11	nov-11	may-12	nov-12	may-13	nov-13	may-14	nov-14	may-15	nov-15	may-16	nov-16	may-17
Germany	67	63	66	65	69	66	71	74	73	76	73	73	80	81
The Netherlands	76	74	71	73	75	68	71	76	75	75	75	77	77	79
Finland	78	77	72	74	76	75	75	76	75	78	74	75	78	77
Lithuania	51	48	46	42	43	40	40	50	63	73	67	65	67	65
Latvia	52	53	42	39	35	43	53	68	74	78	72	78	78	78
Estonia	63	71	64	71	69	73	76	80	84	83	82	78	81	82
Slovakia	89	82	78	80	72	77	78	74	79	81	78	78	81	79
EU-28	58	56	53	52	53	51	53	55	56	57	56	56	58	60

Source: European Commission, Public Opinion

political forces that criticized the approach to the crisis (The Finns) or were hostile toward the common currency (Alternative für Deutschland and Partij voor de Vrijheid). Nevertheless, recent polls show that support for the common currency is still high among the Northern Eurozone countries and well above the EU-28 average. The most recent Eurobarometer polls show that in all of the members of the group, except for Lithuania, support for the euro exceeds 70 percent (Table 2).

[1] In this text, Germany, the Netherlands, Finland, the Baltic states, and Slovakia are classified as the "North" because of the following factors: their insistence on strict obedience to the rules of the currency union, their rejection of permanent fiscal transfers among the member states, and their reliance on each individual member state's responsibility for the euro's sustainability, especially through structural reforms and fiscal consolidation on the national level.

The economic reasons behind the support for the euro

The general economic motives for currency integration are common for all members of the "Northern" group, which are open, competitive economies, with foreign trade playing an important role in their growth models.

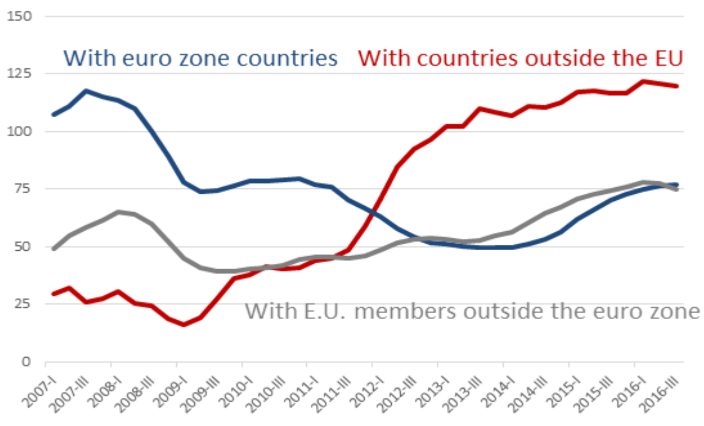
The level of openness of these economies is a clear factor in differentiating the group from the Southern states. As shown in Table 3, the Northern members of the euro area are very open economies with a relatively high share of trade in GDP. Finland's share is somewhat lower, but its economy is also strongly integrated with global value chains.[2] Relying so heavily on trade puts the elimination of exchange rate risks, which could affect domestic business, more centrally into the spotlight.

Other factors in favor of membership in the currency union for most of the members of the group were lower borrowing costs for the governments and better access to capital for the private sector.

The largest economy in the euro and the export champion of the EU-19, Germany, plays a crucial political and economic role in the currency union. Analogous to the birth of the monetary union, the country gradually evolved from the position of the "sick man of Europe" to the anchor of stability for the EU-19, with the interest rates of the German bunds as the main reference point in measuring the development of the crisis.

From Berlin's perspective, there are sound economic arguments for the overwhelming support for the common currency. Yet, the profits from the euro are not always easily proven. Some authors are skeptical about the tangible consequences of the euro on the German economy, as they see no clear positive effects for investments or trade – even indicating some negative effects, as the euro made it easier to locate production outside of the country.[3] Since the

Figure 6
12-month German trade surplus in bil. Dollar



Source: Bundesbank

Table 3
Trade-to-GDP ratio

Slovakia	185%
The Netherlands	154%
Estonia	154%
Lithuania	153%
Latvia	119%
Germany	96%
Finland	74%
Greece	64%
Spain	64%
France	61%
Italy	57%
OECD-Average	57%
USA	56,7%
Japan	36%

Source: Worldbank

[2] Jyrki Ali-Yrkkö, Petri Rouvinen, Pekka Sinko, and Joonas Tuhkuri, *Finland in Global Value Chains* (Helsinki: Prime Minister's Office Publications, December 2016).

[3] Johannes Becker and Clemens Fuest, "Profitiert Deutschland wirklich vom Euro?" *FAZ*, 13 February 2017.

introduction of the euro in 1999, the trade data suggests that the volume of exports and imports to other Eurozone members increased, but not as much as the trade volume with non-euro EU members and countries outside the EU. As a result, the relative share of exports to the euro area in total exports decreased from 46 percent in 1999 to 36 percent in 2015.[4] The high trade surplus was mainly generated through the increase in trade with countries outside of the euro and the EU, especially the United Kingdom and the United States, which can be accounted for by the weaker exchange rate of the euro due to the ECB's quantitative easing. With these two countries alone, Germany achieved almost 100 billion euro of surplus in 2016.[5] An important factor contributing to the decreasing intra-Eurozone share of exports was also the decreased demand of the Eurozone markets due to the global financial crisis and the Eurozone crisis.

The lower debt-financing costs for governments are another important advantage of euro membership. During the Eurozone crisis, Germany profited considerably from the lower borrowing costs, which has contributed toward balancing all the federal budgets since 2014. The general government gross debt level decreased from 81 percent of GDP in 2010 to 68.1 percent in 2016.[6] Some calculations indicate that between 2010 and 2015, the overall savings from lower borrowing costs amounted to 100 billion euro.[7]

However, it seems that the most evident economic benefit from the common currency for Germany was the fact that it facilitated cost competitiveness with other Eurozone members due to the German labor-cost discipline eliminating the instrument of competitive devaluation. For this reason, it was important for Germany to accept Italy into the Eurozone, even if the level of public debt and structural problems in the country caused serious concerns.

Last but not least, an important factor for the support for the common currency in Germany, which remains above 70 percent, is the current economic performance of the country. Some indicators, such as the level of unemployment in 2017, are the lowest since reunification. However, support for the common currency grew steadily during the worst phases of Eurozone crisis, regardless of the slowdown of the German economy in 2012 and 2013.[8]

[4] Federal Statistical Office of Germany (2016).

[5] Federal Statistical Office of Germany, *Foreign Trade, Ranking of Germany's Trading Partners in Foreign Trade* (21 March 2017), retrieved from https://www.destatis.de/EN/FactsFigures/NationalEconomyEnvironment/ForeignTrade/Tables/OrderRankGermanyTradingPartners.pdf?__blob=publicationFile.

[6] Eurostat, *The Value for 2016 Is the Estimate of the European Commission*, see European Commission, *Autumn Economic Forecast*, retrieved from https://ec.europa.eu/info/business-economy-euro/economic-performance-and-forecasts/economic-forecasts/autumn-2016-economic-forecast_en#economic-forecast-by-country.

[7] Leibniz-Institut für Wirtschaftsforschung Halle (IWH) (Ed.), *Germany's Benefit from the Greek Crisis*, *IWH Online* (Halle: Saale, July 2015), retrieved from http://www.iwhhalle.de/fileadmin/user_upload/publications/iwh_online/io_2015-07.pdf.

[8] Wilhelm Knelangen, "Ende des europapolitischen Gleichklangs? Die öffentliche Mei-

In Finland and the Netherlands, Eurozone membership has been a regular subject of vigorous political debates. The economic models of both countries are different. For the Netherlands, international trade has a much more important role. Finland represents a Nordic model, with its strong role for the state and focus on the importance of redistribution mechanisms. The level of state expenses, as a share of its GDP, is one of the highest among the OECD countries.[9] For both economies, the stability of the exchange rate is a great advantage. In Finland, for example, the national currency was relatively unstable in the period before joining the euro area. Euro membership also means lower debt-servicing costs for both states and better access for corporations regarding financing.[10] Although the depreciation of its own currency would have helped Finland to recover after the financial crisis, an exit from the Eurozone would have led to concrete costs and had a negative impact on its exports.[11] Available comparisons between Sweden and Finland lead to the conclusion that Sweden experienced a much faster recovery after the 2009 recession. In Finland, this has led to recurring calls for withdrawal from the euro area in order to improve the country's competitiveness. The Finnish economy has been struggling to regain its strength ever since its traditional drivers of economic growth (IT and telecommunications, paper industry), sanctions on Russia, and the Eurozone crisis have created difficulties for the country.[12]

For the Netherlands, which has a very open economy, strong trade connections within the EU single market, and one of the largest European transport hubs, membership in the monetary union was an attractive option. However, euro area membership has been questioned on several occasions. In the past, some researchers claimed that a withdrawal from the Eurozone would be beneficial for the Dutch economy.[13] However, the most recent findings come to completely different conclusions than the analyses conducted during the hottest phase of the Eurozone crisis. Analysts from Rabobank issued a warning against a Eurozone exit scenario, pointing to several risks for the Dutch economy, such as capital controls, appreciation of the new currency, losses on assets abroad and on the Target 2 claims, as well as a worsening position in international competitiveness.[14] Nevertheless, they admit that the EU single market –

nung zur europäischen Integration in Deutschland, in Katrin Böttger and Mathias Jopp, *Handbuch zur deutschen Europapolitik*, pp. 208–209 (Berlin: Nomos, 2016).

9 Retrieved from https://data.oecd.org/gga/general-government-spending.htm.

10 Timo Korkeamäki, *The Corporate Benefits of the Euro*, FIIA Briefing Paper 103 (Helsinki: The Finnish Institute of International Affairs, April 2012).

11 GnS economics, *Finland and the EMU: Costs, Benefits, and the Way Forward*, GnS economics special report (2012).

12 Tobias Etzold and Paweł Tokarski, *New Centre-Right Government in Finland. Economic and European Challenges and Perspectives*, SWP Comments 35 (Berlin: SWP, June 2015).

13 See for instance: Lombard Street Research, *The Netherlands & the Euro. Special Report*, pp. 41 and 52, retrieved from http://www.nu.nl/files/Netherlands_and_the_Euro_-_Full_Report_Final.pdf.

14 Rabobank, *Four Scenarios for Europe: A Struggling Europe in a Changing World* (Rabo Re-

the most fundamental interest that the Dutch have in the EU – could survive currency disintegration.[15]

Politics matter: From peripheries to the core

The Baltic states launched their preparations to enter the third stage of the EMU during the worst phases of the global financial crisis and the Eurozone crisis.[16]

The reasons for this determination are both economic and political in character. In the case of the Baltic states, the economic rationale for membership in the currency union has been undeniably strong. These economies reduced borrowing and transaction costs and gained access to Eurozone liquidity and financial assistance mechanisms. Another argument of crucial significance in favor of euro area membership for smaller states is the participation in the economic decision-making of the currency bloc. Small economies have had rather limited possibilities to pursue their own independent monetary policies. All three euro members were running currency board arrangements long before EU accession. Therefore, the argument on the loss of an independent monetary policy was not as relevant in the case of the Baltic states as it was with Sweden and Poland. After joining the euro area, each of the Baltic states also received a seat in the main Eurozone institutions. The goal to move from the EU's geographical periphery to its core of economic decision-making was also important from the Finnish point of view. The feeling of political marginalization due to being outside the euro area increased after the EU membership referendum in the United Kingdom. Sharing a common currency additionally increases the likelihood of sticking to the path of closer economic and political integration. For Slovakia, Eurozone accession was a political question at heart and had both strong political and social support. The country, which concluded the EU accession process as the last new member state, was determined to stay in the political core of European integration. However, the costs and benefits of such a step were also carefully calculated by the National Bank of Slovakia, which was in charge of the euro area entry process.[17]

Besides the important economic arguments and the willingness to take part in the core decision-making processes in Brussels, there were security reasons involved in the decisions to stay on the path leading to accession. This motivation was particularly strong in the case of the Baltic states. The political leaders from the Baltic states were looking for any possibility to secure their standing toward Russia due to their unfavorable geopolitical

search, February 2017).

15 Ibid., p. 5.

16 Estonia in 2011, Latvia in 2014, Lithuania in 2015.

17 National Bank of Slovakia, "The Effects of Euro Adoption on the Slovak Economy", (Bratislava: NBS Research Department, March 2006); Martin Šuster, "Slovak Experience with the Euro", in Gostyńska et al., *Eurozone Enlargement in Times of Crisis*, *Challenges for the V4 Countries* (Warsaw: PISM, 2014).

position. The domination of the security factor in the foreign policies of these countries became even more evident after the Russian invasion of Crimea in Ukraine, which occurred at the time of Latvian and Lithuanian accession to the euro.[18] The Baltic states shared the opinion that membership in a Germany-led currency bloc would render any potential aggression less likely, since this would risk the destabilization of the entire monetary union. It is impossible to prove if this argument is right. Still, for the small member states located at the geographic peripheries of the EU, Eurozone membership is a considerable element in the strategy of maintaining the broadest possible security mix.

Concerns over the future of the currency union

Among the Northern Eurozone members, there is strong criticism concerning the situation in the euro area. Some of these countries are reluctant to show more solidarity with the Southern members. In 2010 Slovakia refused to participate in the first financial assistance package for Greece. The question of financial assistance for Greece resurfaced in the other countries in parallel with the Greek crisis, as these countries bear potential financial losses if one or more countries withdraw from the euro, or it could even lead to the disintegration of the entire bloc. In the case of Germany, the total liability through the bilateral loan to Greece, the International Monetary Fund, the European Financial Stabilisation Mechanism, the European Financial Stability Facility, and the European Stability Mechanism amounted to almost 100 billion euro (September 2017).[19] The German Target-2 liabilities, which in August 2017 exceeded 850 billion euro, were widely reported and commented on in the leading media.[20] Despite the hypothetical risk of financial losses and unfavorable monetary policy of the ECB, German participation in the Eurozone is never brought into question by the mainstream political forces. Germany is the largest contributor to the financial assistance packages for the other Eurozone economies. The accommodative monetary policy of the ECB – including two years of a large asset-purchase program – turned out to be costly for the individual savers and credit institutions. In a survey conducted by the Bundesbank, the 1,500 German credit institutions expect pre-tax profits of around 25 percent by 2019.[21] The low interest-rate

[18] See for instance: Richard Milne, "Latvia Sees Joining Euro As Extra Protection against Russia", *Financial Times*, 30 December 2013, retrieved from https://www.ft.com/content/199b0a8c-69c0-11e3-aba3-00144feabdc0; Andrius Sytas, "Lithuania Joins Euro As Tensions with Neighboring Russia Rise", *Reuters*, 31 December 2014, retrieved from http://www.reuters.com/article/us-lithuania-euro-idUSKBN0K918E 20141231.

[19] Ifo Institute, *Financial Assistance for the Euro Countries and Germany's Liability* (September 2017), retrieved from https://www.cesifo-group.de/ifoHome/policy/Finanzhilfen.html.

[20] European Central Bank, *TARGET Balances of Participating NCBs*, retrieved from http://sdw.ecb.europa.eu/reports.do?node=1000004859.

[21] "Ertragslage und Widerstandsfähigkeit deutscher Kreditinstitute im Niedrigzinsumfeld", Pressegespräch mit A. Dombret und R. Röseler am 18. September 2015, retrieved

environment is the main driver behind the considerable increase in real estate prices in the largest German cities.[22] The expansionary monetary policy of the ECB is an object of criticism of many German economists as well as the general public.

Although the risk of Eurozone disintegration has significantly decreased, the uncertainty concerning the future of the currency area persists. This concerns the general question regarding the ultimate desired shape of the EMU and the lack of a concrete answer. There are also several controversies such as the flexibility of rules, the lack of necessary structural reforms in the South, the expansive monetary policy of the ECB, and certain proposals concerning the creation of fiscal transfer mechanisms from the North to the South. Thus, the crisis led to major discussions concerning a reconsideration of the currency union project in the Northern Eurozone countries. For the Netherlands and Finland, a significant risk is attached to drafting the EMU model from the rules-based Maastricht design into the one dominated by the crises in Southern Eurozone member states.

For the Northern Eurozone members, the negative incentive for keeping the common currency is particularly compelling. It is rather certain that a partial or full disintegration of the currency union would be an economic and political disaster for the EU-19 and for the entire EU. This argument is especially significant for Germany, which invested a lot of political and economic capital in the European project. Disintegration of the euro area would entail huge risks for the real economy and public finances of all the Eurozone members. It would also lead to legal and political chaos. Massive financial losses through the financial assistance mechanisms would generate angry reactions from the voters, possibly leading to an increase in support for political extremists. The European economies would face a sharp rise in unemployment and a long recession. A breakup of the Eurozone could also create a destructive domino effect in other policy areas, such as the Single Market, Schengen, or the Common Agricultural Policy.

In economic terms, the end of the euro would probably be less painful for the North than for the South due to the strength of the Northern economies. However, it would trigger new problems. The introduction of new Northern currencies could quickly lead to their substantial appreciation, with negative effects for Northern countries' exports. All of these arguments – the positive economic effects of the euro, the aim to be at the center of the decision-making process, security aspects, and fear of an alternative scenario – make the members of this group interested in maintaining the status quo.

from https://www.bundesbank.de/Redaktion/DE/Downloads/Presse/Pressenotizen/2015/2015_09_18_bafin_bbk.pdf?__blob=publicationFile.

[22] Deutsche Bank Research, "Outlook on the German Housing Market in 2017", *Germany Monitor*, 13 January 2017, retrieved from http://www.dbresearch.com/PROD/DBR_INTERNET_ENPROD/PROD0000000000431730/Outlook_on_the_German_housing_market_in_2017%3A_Pric.pdf.

Conclusion

There is broad consensus that the institutional architecture of the EMU is incomplete; however, the differences in opinions concerning the future direction of the union are substantial. There are numerous voices that say that further fiscal and political integration is necessary, including pooling more resources and creating new institutions, especially a finance minister of the euro and a separate parliamentary chamber for the EU-19. The critics of this approach point out that the individual member states should be responsible for their own economic policies and should make the necessary adjustments through structural reforms and internal devaluations. Further fiscal integration in the absence of sustainable economic policies on the national level would lead to permanent fiscal transfers from the North to the South of the currency union. This argument is especially strong in Germany. In this working paper, the dissonance of opinions has been reflected upon and can be categorized as the most important dilemma in the debate about the future of the EMU. It seems that finding a way between the individual and collective responsibilities of the member states is the main challenge for the future existence of the EMU.

Despite the divergent views on the further direction of Eurozone reforms, there is a large consensus concerning the euro. In both Northern and Southern member states, the common currency enjoys high levels of support among governments and the general public. For the Southern euro area members, the euro is a symbol of stability as well as advancing modernity and strengthening their international positions. This feeling is especially strong in Spain. In several Southern euro area members, the confidence in European institutions is much stronger than in the national ones. This has its roots in historical experiences. For the citizens of Greece, Spain, and Portugal, European integration was a catalyst for successful democratic transition and economic modernization. The citizens of these countries want to keep the euro, despite the harsh fiscal consolidation measures applied during the crisis. In Italy, however, the situation is different. The general public's support for the euro is the second-lowest in the Eurozone after Cyprus. There are also several political forces questioning membership in the currency union. Trapped by high levels of public debt and problems in the banking sector, Italy seems to be the weakest link in the euro area chain. Therefore, the problems of this country – and the reasons behind the skeptical attitude of the general public toward the euro – must be seriously taken into account by the decision-makers in the upcoming political cycle.

The Northern euro area members, with their much more open economies, have had a profound interest in monetary integration. For Germany, it not only brought concrete economic benefits, but it also became the foundation for its European policies. For the North (and also for the

South), euro membership meant lower borrowing costs, the elimination of exchange rate fluctuations, and influence on monetary policies in Europe, which were previously dominated by the Bundesbank. For some member states, an important reason behind accession to the euro area was the willingness to move from the geographical periphery to the core of the decision-making process and to further integrate. For the Baltic states, euro membership is furthermore considered a way to reinforce their security against an aggressive Russia.

Another reason for supporting the status quo is the fear about unpredictable scenarios in the future. The end of the euro would unlikely be managed in an orderly fashion. It could cause chaos and economic recession and would permanently weaken the institutions and policies for European integration.

This working paper is an attempt to map the differences and common points in opinions between the North and the South regarding the euro. More research, especially empirical research, is necessary to examine the reasons behind the widespread enthusiasm as well as skepticism toward the European currency, and to explore the differences in perceptions of the euro between and within both groups. Seventy percent support from the population is a high figure, but almost 30 percent of Eurozone citizens being unenthusiastic about the euro is also high. Despite the fact that the populists in Europe have had some spectacular defeats, there is still a possibility that the euro currency can be used as a scapegoat for the failures in national economies. Even if the recent elections in France ended with a strong defeat of the populists, the results of the first round of the presidential elections – in which the candidates hostile to the euro received more than 40 percent of the votes – should be treated as a warning signal. There is no doubt that the key to strengthening the EMU lies in a successful compromise between Germany and France. However, this tandem needs to seriously take into account the interests of the other Eurozone members.

The Authors

Ognian Hishow works as a lecturer at Free University Berlin, previously Senior Associate at the German Institute for International and Security Affairs in Berlin (SWP).

Miguel Otero-Iglesias is Senior Analyst at the Elcano Royal Institute, an Adjunct Professor at IE University in Madrid and Research Associate at the EU-Asia Institute at ESSCA School of Management (France).

Federico Steinberg is Senior Analyst at the Elcano Royal Institute and Lecturer of Political Economy at Madrid's Universidad Autónoma.

Paweł Tokarski is Senior Associate at the German Institute for International and Security Affairs in Berlin (SWP).