THE ROAD NOT TAKEN: A COMPARISON BETWEEN THE HARD ECU AND THE EURO

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Abstract
In the context of the Eurozone crisis this paper re-examines the Hard ECU using the concepts of the macroeconomic trilemma and the political trilemma. We find that the Hard ECU would have been less economically and politically damaging than the euro. We conclude that it was a superior approach to monetary union.

JEL codes: E42, E52, E58, F02, F32, F33, F41, F45.

Keywords: balance of payments crisis; currency competition; EMU; euro; Hayek; monetary union; optimum currency area.

1. The euro and the crisis

In 2007, on the 50th anniversary of the signing of the Treaty of Rome, the European Commission published *One Currency for One Europe: The Road to the Euro*. In the Foreword Joaquín Almunia, the Commissioner for Economic and Monetary Affairs, praised 'the stability created by the macroeconomic framework of EMU [economic and monetary union] which brings price stability and sound public finances', while the blurb on the back cover hailed the European single currency, the euro, as 'the biggest and most visible success story in the process of European integration'. In 2008, for the euro's tenth anniversary, the European Commission listed 'A better performing economy' and 'Sounder public finances' as two of ten euro 'success stories' (European Commission 2008, p. 2).

Since 2009 the euro has been in crisis. Unemployment and government debt are up and output is down. Furthermore, these experiences have been asymmetric across the Eurozone. The resulting tensions, seen again over Greece in the summer of 2015, threaten the future of both the euro and the European Union itself.

1.1. The euro's economic crisis

The euro is central to this crisis. The approach and advent of the euro saw real interest rates across the Eurozone both fall and converge (De Grauwe and Ji 2012). Capital flowed into the periphery; Eurozone capital flows nearly tripled between 2002 and 2007 (Lane 2013). This pushed up periphery factor prices, with real unit labour costs rising faster than in the core (De Grauwe 2012, pp. 129–31). This led to increasing and persistent divergence in member countries' balance of payments (Lane 2012, pp. 52–3; O'Rourke and Taylor 2013). In 2008 this capital flow suddenly stopped. From a peak of 40 per cent of GDP, capital flows slumped to around 5 per cent of GDP, and the periphery countries were plunged into funding crises (Lane 2013; Milesi-Ferretti and Tille 2011).

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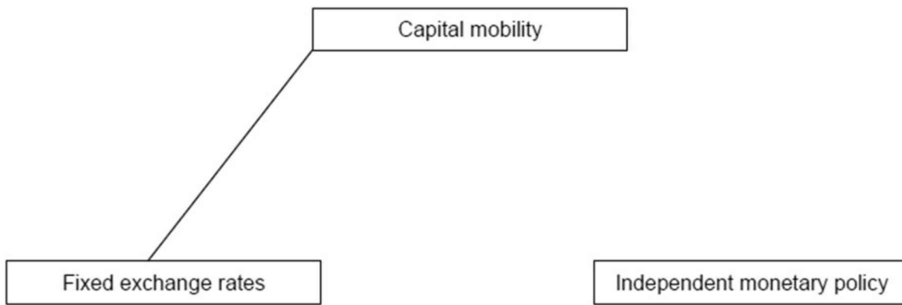

Figure 1: The European Community 'macroeconomic trilemma' choice.

Before the advent of the euro, such payments imbalances could be at least ameliorated by devaluation of the currency. These 'external' devaluations saw one price, the exchange rate, change in nominal and real terms while domestic prices, remaining largely the same nominally, initially at least, would change in real terms. In a monetary union, this is impossible. Domestic prices must fall in nominal terms in an 'internal' devaluation which is highly problematic (Shambaugh 2012, pp. 179–86).

This economic situation can be analysed using the 'macroeconomic trilemma' (O'Rourke 2011; Crafts 2014), according to which it is impossible for a country to achieve simultaneously more than two of the three policy goals of (*a*) full cross-border capital mobility, (*b*) a fixed exchange rate, and (*c*) an independent monetary policy. A country trying to pursue all three goals would find capital movements affecting its exchange rate, necessitating either capital controls or an abandonment of the independent monetary policy in favour of one driven by the need to protect the exchange rate. Consequently, choosing a fixed exchange rate gives policymakers a further choice of either capital mobility, with monetary policy being used to maintain the exchange rate in the face of capital movements, or an independent monetary policy, with capital controls being used to maintain the exchange rate while monetary policy is otherwise engaged (Obstfeld and Taylor 2004). With the euro, member countries have chosen (*a*) an extreme manifestation of a fixed exchange rate and (*b*) capital mobility (see Figure 1).

1.2. The euro's political crisis

The euro's political crisis stems from the fact that the Eurozone's level of political integration is not commensurate with its level of economic integration (Crum 2013). European institutions have usurped the nation state on an ad hoc basis, with bailed-out countries' economic policies being dictated by the 'troika' (the European Commission, the European Central Bank and the International Monetary Fund). But those doing the dictating have not acquired the political accountability of democratic politics, with senior European Union officials such as Jean-Claude Juncker, President of the European Commission, saying 'there can be no democratic choice against the European treaties' (Hewitt 2015). Following Greece's bailout in November 2012, Yanis Varoufakis, Greek finance minister between January and July 2015, wrote:

> So, what will come of Greece, given the latest Eurogroup 'decision'? It is my fear, and belief, that the country is becoming a version of Kosovo – a protectorate in which the euro remains the currency,

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> sovereignty is minimal, the population is ruled over by a glorified kleptocracy with strong links to Berlin and, last but not least, a permanent migratory flow is established that sees the young and the skilled move to northern Europe and beyond. (Varoufakis 2012)

The result is widespread discontent (Pew Research Center 2013).

This political situation can be analysed using the 'political trilemma' (Rodrik 2000). This holds that policymakers can choose any two but not all three of a 'nation-state system, democratic politics, and full economic integration' (Rodrik 2002, p. 1). A high degree of international economic integration removes certain choices from national politics. As a result, policymakers can choose either to keep a nation state system but without democratic choices, or to keep the democratic choices but at a more appropriate level, given their internationalisation, than the nation state. On this analysis, the Eurozone's opting for full economic integration presents it with a consequent 'political trilemma' choice between a nation-state system and democratic politics (see Figure 2). The resolution of the Eurozone crisis hinges on this choice.[1]

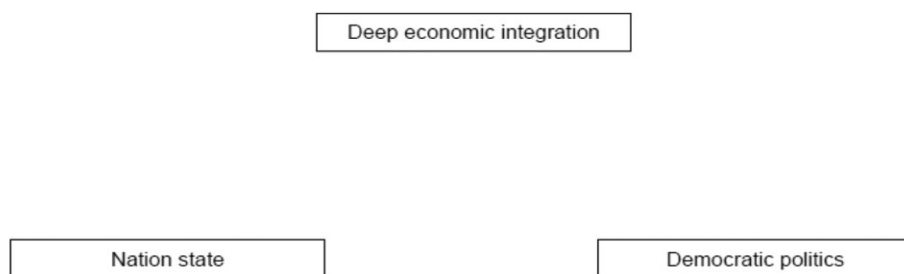

Figure 2: The 'political trilemma'.

1.3. Trilemmas in the Delors Report

These twin trilemma choices and the seeds of the current Eurozone crisis can be found in the Delors Report of 1989 which set out the path to the euro.[2]

The 1957 Treaty of Rome had committed the European Economic Community (as it was then named) to 'the abolition, as between Member States, of obstacles to freedom of movement for persons, services and capital' (European Economic Community 1957, art.3(c)) – Rodrik's deep economic integration. The Single European Act of 1986 reiterated this. It legislated for the creation of an 'internal market' by the end of 1992 which 'shall comprise an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured' (European Commission 1987, art. 8a).

It was a shibboleth of European thought that economic integration required exchange rate stability – that the 'political trilemma' choice of economic integration and its 'macroeconomic trilemma' manifestation of capital mobility necessitated the accompanying choice of a fixed exchange rate. As the Bretton Woods system of fixed exchange rates collapsed in the late 1960s and early 1970s, European policymakers believed that 'The experience of recent years has clearly shown that [exchange rate] disequilibrium is likely to compromise seriously the integration realized in the liberation of the movement of goods, services and capital' (European

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Commission 1970, p. 7). They embarked on a series of attempts to combat this. The first of these was the Werner Report of October 1970. This failed due to what the Delors Report coyly called 'the pressure of divergent policy responses to the economic shocks of the period' (Committee for the Study of Economic and Monetary Union 1989, p. 7; James 2012, pp. 51–2). European Community policymakers moved again, in 1978, to create 'a zone of monetary stability' with the European Monetary System (European Commission 1978, p. 18). Its centrepiece was the Exchange Rate Mechanism, which limited the movement of member currencies to a 2.25 per cent band (6 per cent for the lira) on either side of parity with the European Currency Unit (ECU), a basket representing weighted averages of member currencies.

January 1987 saw a dramatic devaluation of the franc and revaluation of the deutschmark. This was diagnosed as a 'second generation' currency crisis driven by speculative capital, rather than a 'first generation' crisis driven by fundamental disequilibrium in the balance of payments (Gros and Thygesen 1998, p. 83; Krugman 1979; Obstfeld 1986). It was thought that further crises would only become more likely as capital liberalisation proceeded under the single market programme, and the European Monetary System was now deemed too weak a vehicle for exchange rate stability (European Commission 1987, p. 62). The June 1988 Hanover Summit 'decided to entrust to a Committee the task of studying and proposing concrete stages leading towards [monetary] union' (European Commission 1988, p. 166).

With the choice made for deep economic integration in this form, European Community policymakers returned to the 'political trilemma' choice between democratic politics and the nation state. The Delors Report argued that 'Economic and monetary union . . . would imply a common monetary policy and require a high degree of compatibility of economic policies and consistency in a number of other policy areas, particularly in the fiscal field' (Committee for the Study of Economic and Monetary Union 1989, p. 13). It went on (p. 14):

> In the economic field a wide range of decisions would remain the preserve of national and regional authorities. However, given their potential impact on the overall domestic and external economic situation of the Community and their implications for the conduct of a common monetary policy, such decisions would have to be placed within an agreed macroeconomic framework and be subject to binding procedures and rules.

Rather than allocating the power to make these policies to democratically accountable European institutions, the Delors Report and subsequent initiatives, primarily the Maastricht convergence criteria and the later Stability and Growth Pact drafted to underpin the euro, erected a set of rules designed to limit the choices available to democratic policymakers at the national level. This reduced the policy space available to nation states without creating any greater democracy at the international level. The political trilemma choice was fudged.

2. The Hard ECU

2.1. British doubts

'I was', wrote Margaret Thatcher, 'opposed root and branch to the whole approach of the Delors Report' (1993, p. 750). Though much mocked as xenophobic 'Little Englander-ism', British opposition to the Delors Plan was based on an acute and far-sighted appreciation of the twin economic and political dangers.

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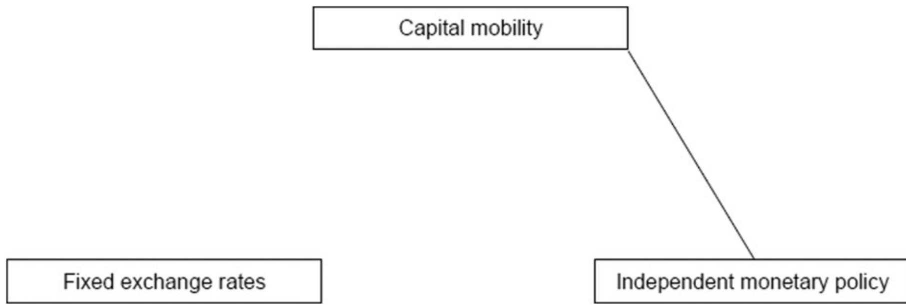

Figure 3: Thatcher's 'macroeconomic trilemma' choice.

2.1.1. Economic concerns On 30 October 1990 Prime Minister Thatcher had the following exchange in the House of Commons (Hansard 1990a):

> **Mr. Terence Higgins (Worthing):** Will my right hon. Friend take time between now and the conference in December to explain to her European colleagues what any first-year economic student could tell them, which is that the imposition of a single currency, as opposed to a common currency, would rule out for all time the most effective means of adjusting for national differences in costs and prices? Will she explain that that in turn would cause widespread unemployment, which would probably exist on a perpetual basis, and very serious financial imbalances?
>
> **The Prime Minister:** Yes, I agree entirely with my right hon. Friend. It would do just that. It would also mean that there would have to be enormous transfers of money from one country to another . . . If we have a single currency or a locked currency, the differences come out substantially in unemployment or vast movements of people from one country to another.

Thatcher worried that relinquishing control over monetary policy would reduce 'national finance ministers to the status of innocent bystanders at the scene of an accident' in the event of macroeconomic shocks (Aitken 1991).[3] In contrast to Britain's European Community partners, in order to retain the tool of monetary policy Thatcher's 'macroeconomic trilemma' choice was for capital mobility and monetary policy autonomy (see Figure 3).[4]

2.1.2. Political concerns British policymakers also foresaw the political problems. In 1989 Nigel Lawson, Britain's Chancellor of the Exchequer, argued:

> The power of the House of Commons over centuries has depended fundamentally on the control of money, both taxation and expenditure. This would be jeopardized by the form of monetary union proposed by the Delors report which would involve central undemocratic direction within Europe of domestic budgetary policies. (House of Commons Treasury and Civil Service Committee 1989, p. xi)

In the Commons Thatcher said (Hansard 1990b):

> When the Delors proposals for economic and monetary union came out, it was said immediately by my right hon. Friend the then Chancellor of the Exchequer that this was not really about monetary policy at all but about a back door to a federal Europe, taking many democratic powers away from

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> democratically elected bodies and giving them to non-elected bodies. I believe fervently that that is true, which is why I shall have nothing to do with their definition of economic and monetary union.

In political trilemma terms, the British choice was clearly for the nation state and democratic politics. But this did not represent a rejection of deep economic integration. Quite the contrary: one of Thatcher's first actions as Prime Minister had been to abolish exchange controls, and she had been a driving force behind the Single European Act. Britain's political trilemma choice was no clearer than Delors'.

2.2. *Competing currencies*

'But I was not in a position to prevent some kind of action being taken upon it', Thatcher wrote later (1993, p. 750). At the Madrid summit in June 1989 'The European Council restated its determination progressively to achieve Economic and Monetary Union' and set a date of July 1990 for the commencement of Stage One (European Commission 1989). Thatcher announced 'that the UK would be putting forward its own proposals for monetary union, as an alternative to the Delors Plan' (Lawson 1993, p. 938).

Thatcher's promise of a British alternative to Delors came as a surprise to her Chancellor, Lawson, with whom, by now, she had a strained relationship.[5] He was faced with somehow reconciling Thatcher's trilemma choices with those of the other European Community members.[6] For inspiration Lawson turned to Friedrich von Hayek's work (Lawson 1993, p. 939). Hayek had long had in mind a notion of currency competition (Hayek 1984, p. 323), but it was the breakdown of the Bretton Woods system and ensuing inflation that prompted him to elaborate his ideas.[7] Hayek argued that inflation resulted from central banks, unconstrained by any commodity or exchange rate anchor, abusing their monopoly position as issuers of legal tender. Hayek proposed to remove this monopoly privilege, allowing anyone to issue currency and use or refuse any currency they wished. Hayek believed that market forces would root out inflationary currencies. He extended this analysis across borders to argue that 'the currencies of those countries trusted to pursue a responsible monetary policy would tend to displace gradually those of a less reliable character' (Hayek 1976, p. 20).

Lawson's plan, formulated in November 1989 as 'An Evolutionary Approach to Economic and Monetary Union' (HM Treasury 1989), drew heavily on this.[8] It took as given Stage One of Delors, essentially complete with the Exchange Rate Mechanism and single market. From there, following 'the complete removal of all unnecessary restrictions on the use of Community currencies'[9] and citing the convergence within the Exchange Rate Mechanism since 1982, it envisaged further convergence on low inflation among member currencies driven by the costs of revaluation compared with devaluation, currency substitution among market participants, and mobile labour and capital favouring low-inflation destinations. The result would be that, as opposed to the 'administrative fiat and institutional change' of Delors,[10]

> Realignments would become rarer, fluctuations within the ERM bands would become smaller, and the EMS could evolve into a system of more or less fixed exchange rates. Concurrently, with minimal exchange rate uncertainty and reduced costs of switching between currencies, all Community currencies would become effectively interchangeable. In this way a practical monetary union would be achieved as the result of a gradual evolutionary process. (HM Treasury 1989)

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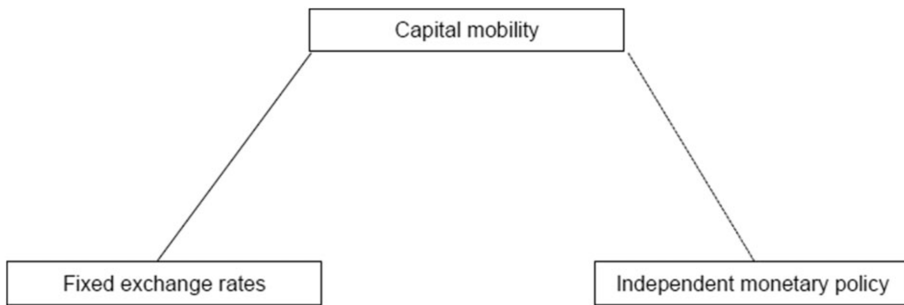

Figure 4: The British 'macroeconomic trilemma' choice.

The Thatcher and continental 'monetary trilemma' choices would be reconciled by fixing exchange rates but keeping the autonomous monetary policy option until such time as it was no longer needed (see Figure 4).

Except from a sceptical Jacques Delors, Lawson claimed a cautious welcome for the idea when he floated it at a summit of European Community finance ministers (ECOFIN) in September 1989 and even detected a 'strong desire' among the other finance ministers for 'a more cautious, step-by-step, approach' than Delors (Lawson 1993, p. 940). John Major, by contrast, who inherited the idea when he took over as Britain's Chancellor in October 1989, thought it 'ingenious' but doomed 'because in a competition between the pound and the deutschmark, the German currency, with its greater depth, liquidity and credibility, was always going to win'. Major recalls a 'mixed reception' when he officially unveiled the scheme at his first ECOFIN meeting in November as it was simply seen as 'a wrecking tactic' (Major 1999, p. 139). Thatcher, while also regarding the scheme as 'ingenious', noted that it 'did not in fact get very far, not least because it was not at all in the statist, centralist model which our European Community partners preferred'.[11] She thought 'that its purpose was mainly tactical in order to slow down discussion of EMU within the Community' (Thatcher 1993, p. 716). Nor was there much support at home with the Treasury, the City, the Bank of England, and businesses all sceptical (Eglene 2011, p. 54).[12]

2.3. *Enter the Hard ECU*

That November Paul Richards, a City economist, conceived another alternative to Delors. In January 1990 he circulated a document titled 'The Next Stage in an Evolutionary Approach to Monetary Union' (Richards 1990a). With the assistance of Sir Michael Butler, a former British Permanent Representative in Brussels who now chaired the European Committee of the British Invisible Exports Council, Richards worked this into an expanded version with the same title which was released in March 1990 (Butler and Richards 1990a). Major launched the scheme as British government policy in a speech to the German Industry Forum in June 1990, and the government's plans for *Possible Treaty Provisions and Statute for a European Monetary Fund* were circulated in final form in January 1991 (HM Treasury 1991).[13]

This alternative, the Hard ECU, grew from two observations. First, Richards noted that 'By calling an Inter-Governmental Conference to revise the Treaty the other member countries have indicated that the [Lawson plan] does not in their view go far enough towards EMU'.

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Thus, 'The question for them is not whether there should be a revision in the Treaty, but what form it should take' and 'in the absence of a viable alternative, the revision in the Treaty is likely to be based on the route to EMU described in Stages 2 and 3 of the Delors Report' (Richards 1990a, pp. 1–2).

Second, there was a belief among British policymakers that Delors had given insufficient attention to the *process* of monetary union.[14] 'European monetary union, as seen in the Delors report and in much of the work of the European Community, is like a Chinese picture', wrote Butler and Richards. 'The activities in the foreground . . . are precisely painted. The peaks of the distant mountains (stage three) stand out in stark simplicity. All between is mist' (Butler and Richards 1990b). Member countries' monetary situations varied greatly and 'This is not going to change in the short, or even medium term', said Robin Leigh-Pemberton, Governor of the Bank of England, who warned

> If the Community moved to full Monetary Union before economic convergence was considerably greater, long-term structural problems could be aggravated and some areas could be quite severely disadvantaged. This could be politically as well as economically divisive. (Bank of England 1990, p. 375)[15]

Therefore, 'there appear to be three main ways in which the UK can approach the Conference', Richards noted. 'One approach would be to veto any revision in the Treaty on the principle that Stage 2 will not be necessary for the foreseeable future.' However, 'The other member countries might proceed to a new Treaty without the UK. The result would be portrayed as a "two-speed" Europe':[16]

> (ii) A second approach would be to attempt to persuade the other participants that more progress should be made towards achieving price stability and that more practical experience should be gained of operating under Stage 1 before proceeding further . . . But it would fail to answer the question of what Stage 2 should contain when it did start.
>
> (iii) A third approach would be to argue for a revision in the Treaty which would be consistent with the UK's objectives, and would also carry sufficient support from other member countries (such as West Germany) that the UK's proposals would be agreed by the Community as a whole in the interests of securing unanimity among its members. (Butler and Richards 1990a, p. 3)

Obstruct, delay, or construct, were Britain's choices. Given the certainty of a Treaty revision and the unacceptability of what Delors, Butler and Richards proposed to construct, building on 'the original Treasury alternative and adapt(ing) it to the new circumstances created by the Council's decision while remaining consistent with the UK's objectives' (Butler and Richards 1990a, p. 3)[17] – Thatcher's macroeconomic trilemma choice of capital mobility and monetary policy autonomy.

2.4. Establishing the Hard ECU

Butler and Richards's path through the Chinese picture was the establishment of a European Monetary Fund (EMF) to manage a 'hardened' version of the European Currency Unit with 'The overriding objective . . . to promote and maintain price stability in the Community as part of the progressive realisation of Economic and Monetary Union' (HM Treasury 1991, p. 3). The

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EMF would be owned by the member countries' central banks (which would remain responsible for managing their currencies so as to keep their fixed but adjustable exchange rate commitments) and it would join them in the European System of Central Banks.[18] To encourage market participants to substitute into Hard ECUs and to exercise monetary discipline, the EMF would manage it 'in such a way it would always be as strong as the strongest national currency'.

> This would mean that the central parities of Community member countries' national currencies could never be revalued in terms of the ECU, though they could be devalued. If a member country revalued the central parity of its national currency against other member countries' national currencies, the ECU would be revalued with it. (Butler and Richards 1990a, pp. 5–7)

2.5. Operating the Hard ECU

The Hard ECU would function like gold under a gold standard, with member currencies exchangeable into and out of Hard ECUs on demand. Within this framework

The monetary operations of the EMF in ECUs could be divided into three main categories

(i) the issue of ECU notes and coin
(ii) banking operations in ECUs; and
(iii) exchange intervention between ECUs and national Community currencies, and between ECUs and third currencies (e.g. dollars). (Richards 1990a, p. 7)

2.5.1. Issue of notes and coin Richards, in fact, saw little initial need for the EMF to issue ECU notes and coin, foreseeing a scenario where 'sterling would continue to be used in national transactions, while ECUs were increasingly used in transactions between the UK and the rest of the Community' (Richards 1990a, p. 4). But eventually a demand could arise for ECU currency. In this case, sterling, for example, would be handed over and ECU notes and coins dispensed in return (see Table 1). The EMF could handle the accumulated sterling in one of two ways;

> One way would be for the issue of ECU notes to be backed by the sterling notes withdrawn from circulation in exchange for them. This would enable the exchange risk arising from the transactions and the profits from seignorage to be kept at national level. The other way would be to invest the proceeds in sterling gilt-edged. The effect would be to reduce the liabilities of the Issue Department of the Bank of England and increase the liabilities of the EMF, and to reduce the Bank of England's holdings of sterling gilt-edged and to increase the holdings of the EMF. (Butler and Richards 1990a, p. 10)

The exchange risk arising in the second instance would be 'borne by the central bank whose currency had been substituted for ECUs, as happens at present in the case of purchases of foreign exchange by member countries from the IMF'. This could provide 'an added incentive to member countries not to devalue their exchange rates' (Butler and Richards 1990a, p. 11).

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Table 1: Exchange of £ notes for ECU notes

Bank of England			
Liabilities	ECUm	Assets	ECUm
£ notes in issue	–100	£ gilt-edged	–100
European Monetary Fund			
Liabilities	ECUm	Assets	ECUm
ECU notes in issue	+100	£ gilt-edged	+100

2.5.2. Banking operations The European Monetary Fund would act as ECU lender of last resort. It would set ECU interest rates which would 'influence national monetary policy, because of the threat that, if national monetary policy was not sufficiently tight, residents could switch their liquid assets denominated in national currency (into) ECUs'. Thus, the European Monetary Fund's control over community policy would increase to the extent that national currencies were swapped for Hard ECUs (Butler and Richards 1990a, p. 11).

2.5.3. Exchange intervention More problematic was the question of exchange intervention. In the event of a country, such as Britain, reaching the bottom of its range against the ECU, 'the Bank of England would be obliged to buy the sterling offered by the market in exchange for ECUs' and it would 'finance the purchase of sterling by borrowing ECUs from the EMF'. The EMF, in turn, would finance this loan of ECUs by 'borrowing from the Bank of England the sterling offered by the market' (Butler and Richards 1990a, p. 11). In order to stop the Bank of England continuing to produce sterling and pass it on to the EMF British policymakers added a repurchase commitment to Butler and Richards' proposal. '[A] key feature of the proposal', Major explained, 'is that there would be an obligation placed on all member states' central Banks to repurchase their own currencies from the EMF for hard currencies' (Major 1990, p. 7). This would serve two purposes: first, it would protect the EMF from 'considerable risks since it would incur Hard ECU liabilities while accumulating holdings of potentially weaker national currencies', and second, it would 'ensure that the EMF did not validate any excessive liquidity creation by individual national central banks' (Bank of England 1990, p. 376) (see Table 2 and Table 3).

Table 2: Purchases of £ from the market at £'s lower intervention margin against ECUs

Bank of England			
Liabilities	ECUm	Assets	ECUm
ECU liability to EMF	+100	£ claim on EMF	+100
Repayment of ECU liability	–100	Use of claim	–100
European Monetary Fund			
Liabilities	ECUm	Assets	ECUm
£ liability to Bank	+100	ECU claim on Bank	+100
Repayment of £ liability	–100	Use of ECU claim	–100

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Table 3: Sales of £ to the market at £'s upper intervention margin against ECUs

Bank of England			
Liabilities	ECUm	Assets	ECUm
£ liability to EMF	+100	ECU claim on EMF	+100
Repayment of £ liability	−100	Use of ECU claim	−100
European Monetary Fund			
Liabilities	ECUm	Assets	ECUm
ECU liability to Bank	+100	£ claim on Bank	+100
Repayment of ECU liability	−100	Use of £ claim	−100

2.6. Towards monetary union and the Hard ECU 'trilemma choice'

With this in place 'individual and business consumers in the Community would have the choice of transacting their business in national currencies or in ECUs'. Rather than a rapid switch to the Hard ECU,

> a likely scenario . . . would be that sterling would continue to be used in national transactions for some time, while ECUs were increasingly used in transactions between the UK and the rest of the Community, thereby reducing exchange rate uncertainty and (with the help of improvements in technology) reducing transactions costs. (Butler and Richards 1990a, p. 4)

This gives a Hard ECU trilemma choice shown in Figure 4: a first choice of capital mobility and fixed exchange rates – the EC choice – but with the choice of switching to capital mobility and an autonomous monetary policy – Thatcher's choice – if circumstances necessitate. The switch from a trilemma choice of capital mobility and autonomous monetary policy to one of capital mobility and fixed exchange rates – the European choice (Figure 1) – would 'be determined by the market preference of individual and business consumers in the Community' (Butler and Richards 1990a, p. 4).

3. The economic problem revisited

3.1. The European approach

The Delors Report admitted that after the introduction of a single currency 'exchange rate adjustments would no longer be available as an instrument to correct economic imbalances within the Community'. It went on:

> Such imbalances might arise because the process of adjustment and restructuring set in motion by the removal of physical, technical and fiscal barriers is unlikely to have an even impact on different regions or always produce satisfactory results within reasonable periods of time. Imbalances might also emanate from labour and other cost developments, external shocks with differing repercussions on individual economies, or divergent economic policies pursued at national level. (Committee for the Study of Economic and Monetary Union 1989, p. 17)

It was argued that 'Measures designed to strengthen the mobility of factors of production and the flexibility of prices would help to deal with such imbalances' and that 'monetary union

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would represent the final result of the process of progressive economic integration in Europe' (Committee for the Study of Economic and Monetary Union 1989, p. 17). In other words, internal imbalance would be unimportant if the Eurozone were an optimal currency area,[19] the theory of which holds that an area could benefit from a single currency if it has mobility of factors of production (capital and labour), integrated product markets, symmetry of shocks, and a central fiscal authority.

As noted, of the factors of production capital is certainly mobile across the Eurozone; but this is a double-edged sword. Capital which can freely flow in, as it did into the periphery between 2002 and 2007, can just as freely not, as it didn't in 2008. The Eurozone scores less strongly on labour mobility. In 2011 0.2 per cent of Europeans had lived in another European country in the previous year, compared with 2.7 per cent of Americans who had lived in another US state. Furthermore, between 2006 and 2011 there was no increase in the responsiveness of migration to unemployment within the Eurozone (OECD 2014).

The effect of the euro on the magnitude of trade has been a matter of debate (Santos Silva and Tenreyro 2010). However, Eurozone countries now, for the most part, send a smaller share of exports to other members than they did when the euro was launched (see Figure 5).

Regarding asymmetry, between 2002 and 2013 the variance of GDP growth rates among a core group of countries (Belgium, France, Germany, Italy, Luxembourg, and the Netherlands) actually rose slightly, suggesting a degree of divergence (see Figure 6). This has, however, reversed since the crash of 2008. For other euro members the story is more mixed. Some have displayed strong convergence with this core group (Estonia, Ireland, Malta, and Slovakia). Others have displayed strong divergence from the core (Austria, Finland, Greece, and Portugal). Others have displayed no strong tendency either way (Cyprus, Latvia, Slovenia, and Spain).

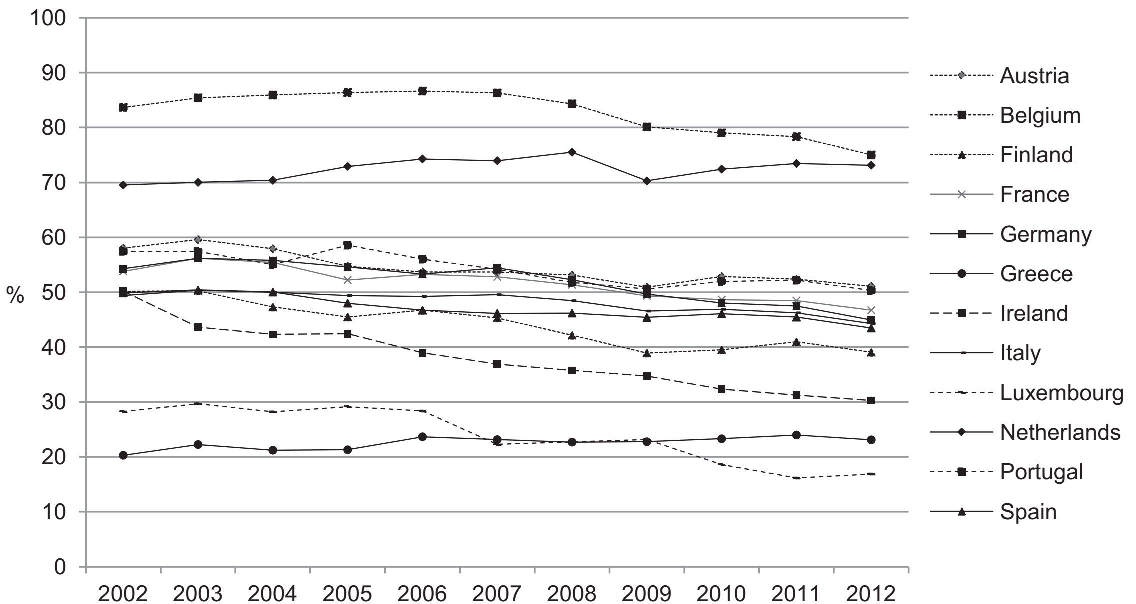

Figure 5: Percentage share of exports of 12 EU member states to all other EU members states, 2002–2012.
Source: Eurostat.

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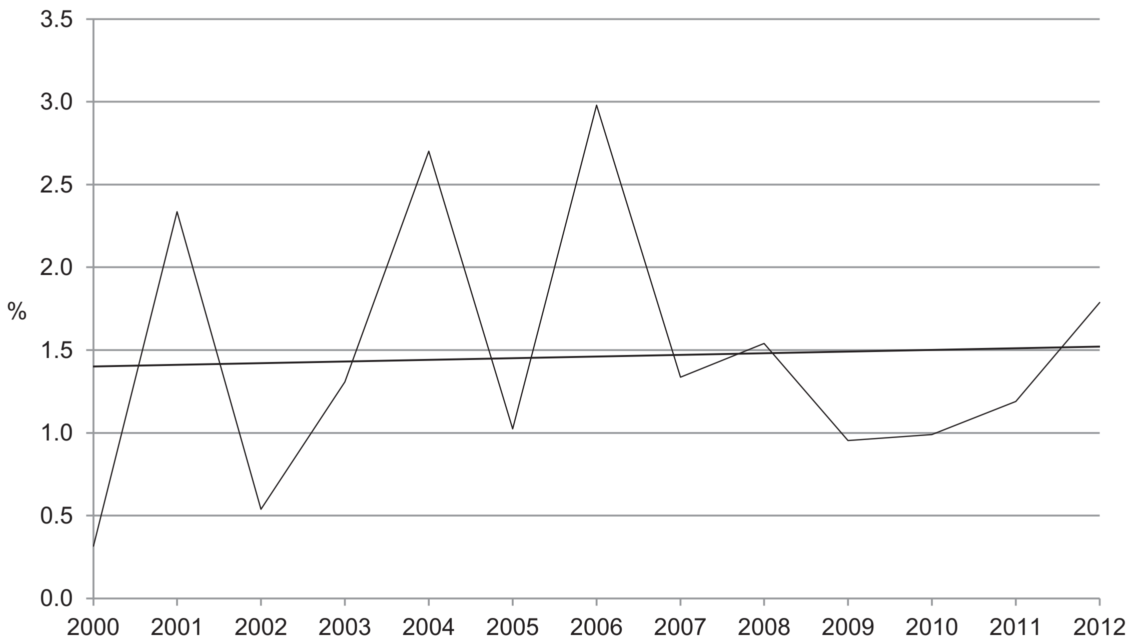

Figure 6: Percentage variance of GDP growth rates for a core group of Eurozone countries, 2000–2012.
Source: Eurostat.

The Maastricht Treaty of 1992 stated 'The Community shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State' (European Council and European Commission 1992, art. 104b). A central fiscal authority was explicitly ruled out by the euro's founding document. Discussing federal fiscal stabiliser effects for the United States, O'Rourke and Taylor (2013, p. 179) report that 'a recent estimate based on income tax alone shows an offset of 28 cents for a state-level $1 income loss, while among Eurozone countries, the corresponding figure is effectively nil'.

3.3. The British approach

British policymakers were sceptical of whether the European Community met the optimal currency area criteria. Indeed, this was the source of the second concern which gave rise to the Hard ECU. Major warned that 'without greatly increased convergence, monetary union simply would not work. A premature attempt to implement it would be unsustainable, and hence a huge setback, damaging both economically and politically, and would lead not to unity, but to disunity' (Major 1990, p. 4). With this in mind, during the period of convergence allowed by the Hard ECU devaluations would be 'discouraged, though not in the last resort . . . ruled out' (Richards 1990c, p. 5).

Some saw this as a drawback of the Hard ECU. Fry argued that 'Proposals for a lengthy transition and gradual introduction of the ECU as a parallel currency appear oblivious to the inherent fragility of a fixed-rate multicurrency system with complete capital mobility'; in other

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words, ‘second generation’ crises requiring realignments would bar the path to monetary union (Fry 1991, p. 486). As a result, Goodhart explained, ‘there is, I believe, a case for going straight to an irrevocably fixed rate without going through the tricky interregnum of a fixed, but adjustable, parity’ (1989, p. 12).

This revisits the ‘economists’ versus ‘monetarists’ debate in the decades before monetary union. As James explains, ‘European “monetarists” believed that the establishment of a series of monetary rules might create the framework for general economic convergence, whereas “economists” stressed that convergence needed to precede the imposition of a single monetary framework’ (James 2012, p. 93; Marsh 2011, pp. 45–6).

Experience now shows that the British policymakers were right (the Eurozone wasn’t an optimal currency area) and the European ‘economists’ were right (the single currency didn’t make it one). The launch of the euro in 1999 and the introduction of euro currency in 2002 were not followed by convergence as the ‘monetarists’ had hoped. It was followed by – indeed it facilitated – economic divergence between member states’ competitive positions, which led to increasing and persistent divergence in member countries’ balance of payments (De Grauwe 2012, pp. 129–31). ‘The consensus view when European Union took place’, wrote Lewis and Mizen (2000, p. 395), ‘was that the optimal currency area criteria are as much outcomes as prerequisites’. This view seems wrong, at least in the European context.

Euro periphery countries are not facing ‘second generation’ but ‘first generation’ crises, those driven by unsustainable economic fundamentals, and they are facing them without the option of external devaluation. Given that the Eurozone is not an optimal currency area, it follows that it should not have a single currency. Bluntly, some members should not be in the monetary union. In the light of experience a scheme such as the Hard ECU, which would have prolonged the prior convergence period until such time as member states were ready to join the union, or even prevented them from entering it altogether, would appear preferable to the path taken.

4. The political problem revisited

The European Community fudged its ‘political trilemma’ choice between the nation state and democratic politics. It left economic policymaking with national governments but, via treaties, denied them some policy choices, so creating a ‘golden straitjacket’ (Rodrik 2000). This has proved unsustainable and the Eurozone is now belatedly facing the choice between the nation state and democratic politics (Crum 2013).

The Hard ECU likewise avoided a clear choice on the ‘political trilemma’. ‘Responsibility for the hard ECU would rest solely with the EMF’, Richards (1990b) wrote, but ‘Decisions about national monetary policy would continue to be taken at national level’. So, too, would decisions concerning national fiscal policies. True, in the first instance these decisions would have to be made with the aim of protecting the domestic currency’s Hard ECU parity, but, *in extremis*, democratically elected, national officials could alter this parity. This choice would have remained until such time as nations no longer needed it. The Hard ECU would have provided ‘greater policy space’ (Crafts 2014, p. 713) for elected, national officials.

But this does not represent a ‘political trilemma’ choice for democratic politics and the nation state and against deep economic integration. Rather, it represents a choice against the Delors conception of deep economic integration requiring a single currency. Despite what

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European Community policymakers believed, it is far from clear that economic integration does require a single currency. The period of the single currency has seen a slight decline in the intra-Eurozone share of member nations' trade. Capital flows increased but this was part of a global phenomenon; between 1999–2002 and 2007–10 the increase in the share of foreign assets and liabilities as a share of own GDP was greater in the United States than in the Eurozone (European Central Bank 2012, p. 108). And, in 2008, capital flows within the Eurozone decreased as sharply as they had previously increased.

One market does not need one money. Indeed, by allowing for devaluation as a tool so long as it was needed, the Hard ECU would have allowed capital mobility to be maintained in the face of imbalances such as the Eurozone currently faces by allowing the switch from fixed exchange rates to independent monetary policy in the macroeconomic trilemma. Under the euro, by contrast, both Cyprus and Greece have seen capital controls introduced.

5. Conclusion: the road not taken

When the Maastricht Treaty, which enshrined Delors' plan, was signed in February 1992, the Hard ECU was consigned to the famous 'dustbin of history'. With hindsight, this seems unfortunate. The Eurozone contains disparate economies some of which desperately need the tool of devaluation, which the euro denies them. The Hard ECU would have allowed them this tool until such time as they no longer needed it. If that time didn't come, then they should not have joined the single currency. Politically, by giving democratically accountable domestic policymakers the 'greater policy space' offered by devaluation, the Hard ECU would have generated less of the resentment that the euro currently fuels. As the Eurozone endures a fifth consecutive year of unemployment above 10 per cent, we can note Taylor's comments from 1997:

> Although the scheme as put forward may have had shortcomings . . . its rejection in favour of the Delors blueprint for EMU was not self-evidently a matter of regret only for Little-Englanders and extreme free-marketeers. (Taylor 1997, p. 5)

Notes

1. In July 2015 French President François Hollande floated the idea of a parliament for the Eurozone (Williamson 2015).
2. Jacques Delors was President of the European Commission from 1985 to 1994.
3. Thatcher's concerns were echoed by academic economists; Drea and Jonung (2009) and Feldstein (2009) provide a good summary of this debate.
4. Thatcher was forced to surrender this position by stages through 1990 in the face of Major's insistence on Britain's ERM membership (Major 1999, pp. 157–62).
5. It came as such a surprise to Peter Middleton, Permanent Secretary to the Treasury, who heard the news while driving, that he nearly crashed his car into a tree (Lawson 1993, p. 939).
6. Lawson shared the continental monetary choice, seeking fixed exchange rates specifically to curb monetary policy autonomy. This disagreement with Thatcher led to his resignation in October 1989 (Lawson 1993, pp. 418–20). His view was shared by continental central bankers, which helps explain their preference for a single currency (Connolly 1995, p. 269; White 1999, p. 207).
7. There were similar schemes afoot. In 1975 a group of economists published 'The All Saints' Day Manifesto for European Monetary Union' in *The Economist*, which advocated a parallel currency (Basevi et al. 1975). Roland Vaubel, drawing directly on Hayek, advocated *Choice in European Monetary Union* (1979).
8. Again, there were similar ideas circulating; see Walters (1990) and Chown and Wood (1990). Issing (2000) finds Hayek's fingerprints on the design of the euro. Fry (1990) provides a good overview of alternative schemes.

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9. Such as Germany's Currency Law, which prohibits the use of foreign currencies in payments and contracts between Germans (Vaubel 1990, p. 940).
10. Lawson was an ardent advocate of British membership of the ERM but an equally ardent opponent of EMU (Lawson 1993).
11. The ingenuity of the scheme is in little doubt. Stephens (1997, p. 160) also calls it 'ingenious'.
12. A Treasury official described it as 'just another of Nigel's clever ideas' (Stephens 1997, p. 161).
13. A full account of the Hard ECU's life as policy can be found in Dyson and Featherstone (1999).
14. A belief shared by others; see Filc (1991, p. 167) and Utzig (1991).
15. Nor was this the only such prescient warning; see Major (1990, p. 4). Leigh-Pemberton signed off the Delors Report all the same.
16. This was a perennial fear in British policymaking (Campbell 2003, p. 702). When Major warned Thatcher of a 'two speed Europe' in April 1990 Thatcher replied, 'What's wrong with that if the other tier is going in the wrong direction?' (Marsh 2011, p. 301). In the event, with the attainment and exercise of the UK's opt-out from the single currency at the intergovernmental conference in Maastricht in December 1991, this was more or less the eventual outcome.
17. The reference to West Germany as a potential ally was absent from the redraft of March 1990.
18. It was optimistically suggested that the EMF could be based in London (Butler and Richards 1990a, pp. 16–17).
19. See Mundell (1961), Kenen (1969), Krugman and Obstfeld (2008, pp. 582–7), and Baldwin and Wyplosz (2012, pp. 401–32). EC policymakers were dismissive of such analysis (Emerson, Gros and Italianer 1992, p. 46).

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