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The Political Economy of Participation in the Euro: A Case Study of Italy and Germany

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The Political Economy of Participation in the Euro
A Case Study of Italy and Germany

submitted to
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by
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Introduction

The creation of the euro in many ways represents a critically important milestone in the history of European integration. Appropriately, it has been studied and analysed at enormous length, both in terms of its political significance and in terms of its long term economic impacts. Many of these analyses however address the motivations for participating in monetary union primarily in political terms, often at the expense of economic interests.¹

This argument, though valid, is normally framed in the following manner: pick a point in time, usually a few hundred years ago, and assert that the vision of a united Europe began then (common options include Charlemagne, Napoleon, etc.). Then, trace the history of Europe ever since, and cite on some of the many powerful and insightful figures who believed in the European project. Recall the horror of war (twice), and finally conclude that post-war Europe is committed to learning from its mistakes and forming ‘ever-closer’ union in order to foreclose the possibility of war on the continent ever again. This reading of history is largely accurate, and explains much of the rationale behind monetary integration. However, it does not capture the range of valid economic motivations that also drove Italy and Germany in supporting the creation of the euro. The purpose of this thesis is to identify and highlight the economic rationales behind participation in monetary union that helped motivate Italy and Germany. This is not to deny the political and aspirational nature of the European Union, as the ideal of ‘ever closer union’ is clearly fundamental to the project of European integration. Rather, the purpose is to nuance and rebalance the dominant narrative surrounding the creation of the euro in Italy

¹ Prominent examples include Eichengreen, Frieden, Jones, Boltho, and Chabot.
and Germany. Those two nations have been selected for both their importance within Europe and the because they contrast each other in many significant ways. In modern European commentary, they are often posited as sitting at two ends of the European spectrum, so better understanding these two nations should hopefully help us better understand the rest of Europe as well.

The Italian decision to participate in monetary union was motivated, at least in part, by a strong desire to finally curtail persistently high inflation and generally weak and ineffective monetary policy. The creation of the European Central Bank effectively outsourced monetary policy to Europe, thereby sidestepping the political obstacles that had weighed down Italian policy making in the past. By outsourcing monetary policy to the European level, Italy was able to import German credibility and low inflation. This politically astute manoeuvre brought economic benefits by guaranteeing even greater access to the European market and the complete removal of foreign exchange risk within Europe. Additionally, by finally getting inflation under control, Italy was able to improve its standing in both domestic and foreign capital markets. The political costs of this newly orthodox monetary policy were not absorbed by domestic Italian actors. Instead, as a result of the institutionalisation of European control over monetary policy, Europe absorbed the political costs. This is reflected in data from elections to the European Parliament and, most reliably, in Eurobarometer polling data from the period.

German participation in monetary union was driven by both a desire to mitigate the political costs of the regionally hegemonic position of the deutschmark and advance the economic interests of German industry. By institutionalising a stable, orthodox, and federalised
monetary policy management regime in the form of the euro system, Germany was able to protect its all-important commitment to low inflation while also benefiting from the positive image of European branding and improved European market access for German firms. Without reliable US leadership in the field of foreign exchange, Europe had to go it alone, and though the Germans baulked at shouldering that burden entirely themselves, they nonetheless were able to work with the rest of Europe to develop a comprehensive solution. Crucially, the euro was expected at the time by German leaders to deliver tangible economic benefits through the continuation of orthodox monetary policy, its lack of appreciation relative to the likely path of the deutschmark, and the prevention of competitive devaluations elsewhere in Europe.

Economic priorities, channelled through the complicated realities of politics, were a central part of the German decision to take part in monetary union.

For both case studies, the analysis presented here is meant to augment existing work on the political motivations behind the creation of the euro. The new contribution of this work is to highlight the transfer of political costs from Italy to Europe through the ECB, and to emphasise the extent to which the economic benefits of the euro were understood by Germany at the time, rather than only becoming apparent after the fact.

The importance of understanding the motivations behind the creation of the euro is clear, particularly as the euro faces both new threats and opportunities. Brexit represents the potential demise of the entire idea of a common currency, whereas the reform proposals championed by Macron stand as the antithesis of Brexit: they represent the potential for a bright, long future for the euro. Understanding the creation of the euro might help europhiles as we work to preserve and strengthen the euro today, that it might be around tomorrow.
Italy: Outsourcing Monetary Policy to the Germans and Importing Low Inflation

Understanding the context around Italy’s decision to participate in the creation of monetary union begins with a recognition of the poor quality of Italian monetary policy prior to the introduction of the euro. Italy faced high inflation, high inflationary expectations, excessive levels of government borrowing, and insufficient institutional capacity to reign in monetary policy deficiencies.² One justification for adopting the euro is to transfer control of monetary policy to the European level. This would effectively address domestic governance issues pertaining to monetary policy.³ It also ensures that Italian politicians in the future are unable to unduly influence monetary policy, by virtue of the independence of the ECB.⁴ As this chapter will explore later, there is significant evidence that the Italians (both the government and the people themselves) saw the euro in precisely this way, as a means of using Europe to advance and overcome domestic Italian weakness.

Phrasing this transfer as one in which Europe takes over monetary policy is not, however, entirely accurate. Given the central position of Germany in the European economy and German dominance in setting foreign exchange and interest rates, a ‘European’ institutional approach to setting monetary policy can be seen as a very close proxy of a German

³ The actual efficacy of European monetary policy, particularly given the (still) broad divergence of economic conditions across the monetary bloc, is up for debate. Though this question is not directly tackled here, broadly speaking it is sufficient for my argument to accept that European monetary policy is preferably to Italian monetary policy.
⁴ As the chapter on Germany explores in more depth, German influence leading up the Maastricht Treaty was critical in enshrining the position of the ECB as independent. This fits well with my narrative that Italy was, in effect, seeking to carry out a transfer of German low-inflationary credibility.
approach to monetary policy. This is critical, particularly given the relatively orthodox position of the Bundesbank on inflation and Germany’s long track record of strong and stable monetary policy. Globally, but even more so in contrast to Italy, Germany stands out as one of the most reputable and steadfast guardians of orthodox monetary policy. By outsourcing control over monetary policy to the ECB, Italy therefore effectively sought to import German credibility and low inflationary expectations, to the benefit of domestic economic interests.

Instead, the euro, as an institutional manifestation of European monetary integration, represents an incremental improvement over the largely unchecked German monetary hegemony that de facto came to exist in Europe following the collapse of Bretton Woods. The size and importance of the German economy, coupled with the trusted position of the deutschmark, meant that the rest of Europe was obliged to follow Germany in matters of monetary policy. Supporting the creation of the euro then not only allows Italy to share in the benefits of German orthodoxy, but also to limit German control over European monetary policy within the parameters of the institutional framework of the euro and the euro system.

Another way of understanding Italian support for the euro is to recognise that, conceptually, adopting the euro served as a tightening of the external constraint in Italy. It is necessary to recall that Italy, by virtue of the strength of the German economy within Europe, was already relatively constrained in its monetary policy. This decision should then be

interpreted relative to cost of giving up domestic monetary policy (the tightening) and the impact of a tighter external constraint. Given that Italian monetary policy was already limited to within a relatively narrow band of German policy, there wasn’t much freedom to lose. Additionally, the generally ineffective nature of Italian monetary policy meant that the costs were minimal and far outweighed by the perceived economic benefits of adopting the euro.

These benefits take two forms: monetary and real. Monetary benefits primarily took the form of improvements in foreign exchange volatility and in the setting of interest rates. Sound and reliable monetary policy, something which was largely foreign to Italy at the time, would constitute a genuine positive shock to the economic system. The real benefits of monetary union were varied, but primarily manifested themselves in improvements in the terms of trade within Europe, the removal of foreign exchange rate risk (and associated benefits for investment and trade), and the broadly stabilising effects of decreased inflation.

The focus of this chapter is then to specifically explore and contextualise how Italy used political manoeuvring around the creation of monetary union to transfer management of monetary policy to the European level, thereby finally curtailing domestic inflation by harnessing German monetary policy credibility. For the Italians, one of the most significant reasons driving their participation in monetary union was improving monetary policy, and attaining the various economic benefits that would bring, most importantly in terms of inflation. This process, whereby Italian politicians gained the ability to defer blame for difficult monetary policy decisions to the European level, effectively sidestepped the deeply entrenched weaknesses that had weakened Italian policy making in the past. In order to confirm the hypothesis that the costs of orthodox monetary policy were transferred to the European level
from the Italian, one would expect to see deteriorating sentiment towards the EU, and in particular the euro, shortly after the formal introduction of the euro as legal tender in the lives of ordinary Italians. A later section will begin the process of analysing data to determine whether there is sufficient support for this hypothesis.

The value add of this analysis is to highlight and emphasise the transfer Italy effectuated in terms of monetary policy, whereby Italy externalised the political costs of curtailing inflation to Europe and internalised the benefits of German credibility. Scholars, including Bastasin and Bardone and Reitano amongst others, have argued that Italy entered the Euro in order to apply external pressure from Europe to Italy’s problems, thereby avoiding domestic political considerations.6 This perspective, though certainly present in the literature, has been underappreciated and overlooked in favour of other analyses.7 However, even these scholars have not specifically explored the transfer of political costs from Italy to Europe, either conceptually or in subsequent data from elections and polling.

The analysis presented here does not touch on whether the euro has successfully brought about improved monetary policy or generally improved fiscal discipline, since its adoption. Though it touches on the effects of the process of adopting the euro (i.e. conforming to the requirements of the Maastricht Treaty and its predecessors), the focus of doing so is to understand the impact of those reforms on the decision to support monetary union. In

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7 Eichengreen and Frieden are two examples of prominent scholars that focus on political rationales for Italian participation in monetary union, in addition to many others.
hindsight, it has become clear, regardless of what Italian politicians thought at the time, that the euro has been at best incomplete medicine for the complicated problems facing Italy, most of which are clearly domestic in nature and pertain to the rigid labour market, lack of competition amongst large firms in key industries, severe economic inequality and persistent corruption. Others have extensively examined the effects of the euro on Italy, so this chapter is instead focused on the process of adopting the euro and the rationale used therefore.

Italian Monetary Policy: Inflation, Borrowing, and Political Interference

For quite some time, Italian monetary policy had been characterised by persistently high inflation, excessive levels of borrowing, and a generally poor reputation, both domestically and internationally. 8 Between 1973 and 1984, the rate of inflation was never lower than 10%.

Figure 1-CPI from 1960-2000 (OECD 2017)

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8 Frieden, Jeffry A. Currency Politics. Princeton: Princeton University Press, 2015, 147. Though the focus is not presently to analyse the root causes of this dysfunction, it is however necessary to establish that the problem lay not with the difficulty of defining appropriate monetary policy in the Italian context, but rather with poor policy outcomes per se.

In stark contrast to the independence of the ECB and the Bundesbank, the Italian central bank for many years was legally required to purchase treasury bonds issued by the Italian government. This arrangement, which today is highly unusual, effectively meant that the treasury, and hence the politicians that ran the treasury, could issue debt with impunity, without any concern for yields, demand, or the mechanisms of supply and demand in the market. In any context in which the government must regularly appeal to the people for support through elections, this lack of an independent check on spending poses a severe threat to fiscal discipline.

The consequences of this arrangement were quite severe. Italian inflation, though in part also driven by persistently high inflationary expectations, was exacerbated by irresponsibly high levels of government spending and debt accumulation. This cycle was also to blame for the lack of credibility of the Italian central bank, which was insufficiently able to act as a constraint on the net monetary and fiscal position of the government. Even though the requirement that the central bank purchase treasury bonds was finally removed in 1981, this did little to improve the quality or effectiveness of Italian monetary policy. Larger problems, namely the lack of effective policy tools, a broad lack of discipline, and high inflation, persisted. In joining the euro, and precursors like the European Monetary System, Italy had to overcome the problem posed by its high rate of inflation, unstable monetary policy, and the variability of

13 Ibid, 117.
the lira. The deficient state of monetary policy making was reflected in the media of the time; a plurality of newspaper articles surveyed by one scholar argued that Italy was behind Europe in key areas.

Foreign Exchange in Europe Post Bretton Woods: The Italian Experience

Italian monetary policy must generally be contextualised as being constrained within the global order of the day. Throughout the era of Bretton Woods (from 1944 to 1971), Italy, along with the rest of Europe, was effectively tied to the US monetary policy. This system provided the necessary stability for quite some time, but the unreliability of the dollar hampered its effectiveness. Europe, in many ways bound together through the nature of cooperation on monetary policy, ultimately became disillusioned with US hegemony over the system. Even after the collapse of Bretton Woods, in 1971, US policy remained focused on domestic concerns at the expense of European interests.

14 (Collins and Giavazzi 2014) argue that inflationary expectations on the national level had converged across Europe by the end of the 20th century, thereby facilitating the transition to the euro. However, the facts don’t support their argument, primarily because inflation in Italy remained higher than in Germany leading up to and during the start of the EMS.


The so-called “Smithsonian Agreement”, a temporary placeholder created in 1971 to take over from the now defunct Bretton Woods framework, suffered similar problems to its predecessor. In both 1972 and 1973, for example, the US let the dollar devalue significantly. Devaluation brought domestic benefits to the US through cheaper exports, but inflicted significant pain on Europe. Because of the central peg to the gold standard, European currencies were forced to move in sync to the dollar in order to maintain their central peg. In 1973 the US moved so suddenly and significantly that Italy was forced to withdraw from the system altogether. Fundamentally, the system benefited from a high degree of coordination, but lacked the political will and commitment necessary to be effective.

There are two main points we can draw from this: first, the persistent demand for stable exchange rates; second that, post Bretton Woods, Europe had to look closer to home to meet that demand for stable foreign exchange. Since 1914, coordinated global efforts to smooth out the wild fluctuations in asset prices and exchange rates had created the expectation that, not only would rates themselves be relatively stable, but also that capital would be able to flow freely. This shift began in Europe with the European Economic Community, which lowered the cost of trade, thereby leading to a quadrupling of trade between 1958 and 1968.
extent to which trade depends on stable foreign exchange rates (or deep and liquid financial markets in which risk related to foreign exchange can be hedged), Europe therefore had to ensure that it had an effective regime in place for managing foreign exchange. As significant financial integration occurred in the 1980s, a truly global market for short term, relatively low risk capital emerged. This financial integration led to a marked increase in current account imbalances across Europe. Given that Europe had learned not to depend on the US any more than necessary for monetary policy, Europe then had to devise an alternative solution to managing foreign exchange risk. In many ways, the euro is a direct response to this need.

European Influence: Monetary Orthodoxy and Relative Stability

When Italy first joined the EMS in 1978, in recognition of the instability of the lira and the problems that the high rate of inflation would cause, a special, extra wide band was negotiated. Whereas other participating states had to remain within narrow bands of ±2.25% relative to the central rate, Italy was granted a full ±6%. The overall performance of the EMS, particularly post 1987 however, was impressive under the circumstances. In particular, the French proved to be incredibly dedicated to maintaining the system.

The EMS only began operating in 1979.
29 Ibid.
As some scholars have argued, Italian participation in the EMS already began to improve policy making and outcomes.\textsuperscript{30} Critically, the EMS imposed a greater degree of orthodoxy on Italian policy making, primarily through tightening the external constraint. Domestic rates were now severely constrained, as any significant shift would lead to a corresponding appreciation or devaluation of the lira. Given that the lira was now bound within the EMS, Italian policy on what might otherwise appear to be a purely domestic issue was similarly constrained. This created and then reinforced a positive feedback loop, in which the Italian political establishment came to see the turn to more European influence in policy setting as a catalyst of better policy outcomes.\textsuperscript{31} Politically, participation in the EMS also made sense. The costs of increased orthodoxy (politicians were now less able to turn to monetary policy to provide short term solutions to their problems), were largely externalised to Europe, which otherwise benefited from enormous positive sentiment.\textsuperscript{32}

Beyond monetary stabilisation, participating in monetary union required a much broader set of reforms.\textsuperscript{33} In order to fulfil euro ascension requirements, Italy had to complete a set of privatisations and significantly consolidate its fiscal position. The extent to which these pressures were effective is relative, as Italy still faced a relatively high debt burden when it did finally join the euro, but they nonetheless provided a welcome counterpoint to domestic

politics. Here as well, participation in monetary union served to shift policy outcomes further towards economic orthodoxy than domestic Italian politics likely would have produced on their own. Given that Italy had for a long time struggled to instil any discipline at all, this was a welcome change for Rome.

European integration had another credit on its resume: the successful experience of the EEC. As several scholars have shown, the cost of trade with the rest of Europe significantly decreased through the creation and subsequent implementation of the EEC. Powerful domestic interests, such as the manufacturing sector, were well served by this increase in European integration and logically supported further improvements in their terms of trade. This was one of the key factors that led to a fourfold increase in trade within Europe during this period. Finally, a cursory glance at the above graph of Italian inflation over time clearly underscores the moderating influence of Europe. Through participating in the various iterations of cooperation preceding monetary union, Italy was finally able to bring domestic inflation under control. Public perception also in many ways reflected this. A large plurality of subjects interviewed about the EMU saw the euro in precisely this way: as a means of bringing Italy up to the level of Europe. This perspective was in part informed by the newspapers of the period, a plurality of which argued that Italy was behind the rest of Europe.

37 Ibid, 38.
However, it is necessary to note that European integration has rarely been a smooth process. Politicians have repeatedly had to overcome a range of difficulties in achieving the goal of ever closer union. The financial crisis of 1992 is one such example.\textsuperscript{38} The Exchange Rate Mechanism depended on coordination between politicians across Europe, and as such was only as strong as their commitment to it. The Danes provided the initial spark by voting down the Maastricht treaty, the document that would eventually herald the start of true monetary union.\textsuperscript{39} This political event highlighted the economic weakness of the ERM system, and speculators, most famously George Soros, attacked.\textsuperscript{40} They reasoned that, given the shock of the Danish referendum and relatively high inflation in Italy and the UK, that the lira and pound would be forced to break the bands tying them to the deutschmark. Capital started flowing out of Italy and the UK and into Germany, as investors worried that the lira and pound would devalue. This expanded the supply of capital in Germany, so the Bundesbank raised rates to tighten monetary conditions.\textsuperscript{41} This served only to exacerbate flows, and Italy and the UK were forced to float their currencies and break from the ERM. The Germans could have saved them by lowering rates, but the Bundesbank could not be swayed. This is only one example of the core tension that the EMS introduced in Europe: the dominant position of the deutschmark forced other countries to either align their monetary policy to that of Germany or to devalue.\textsuperscript{42}

Despite this difficult episode occurring so late in the process, the fundamental arguments in favour of monetary union remained unchanged. The economic situation in Europe gradually improved, and the winds of political favour once again aligned with European integration, allowing the Maastricht treaty to go into effect.\textsuperscript{43} On net, the impact of Europe on Italian monetary policy remained clearly positive, particularly in comparison with domestic Italian policy making. This positive experience was the key driving factor behind the support of Italian politicians who saw the adoption of monetary union as an effective way of improving monetary policy making and thereby finally controlling inflation.

Transferring Low Inflation and Monetary Credibility from Germany

Participation in monetary union effectively triggered two ongoing transfers from Germany to Italy: first, the specificity and transparency of monetary union itself served as an effective way of establishing a robust commitment to lowering inflation.\textsuperscript{44} Second, the credibility and reputation of the Bundesbank, as one of the most orthodox and independent central banks, underpinned the new euro, thereby subsidising the integrity of Italian euros.\textsuperscript{45}

The effect of European influence on Italian inflation is clear to see from Figure 1. Through participation in a clearly defined multilateral system that sought to achieve price stability, Italy was able to overcome domestic weaknesses and political pressures. In contrast to Italian monetary policy, which often focused on medium term target setting and was, at times,

quite volatile; the relative stability of Europe was a welcome improvement. Even with the early failures of the ERM and political and economic tensions, the EMS was unequivocally committed to minimising volatility in foreign exchange markets and imposing greater monetary orthodoxy on its members. Through participating in this European initiative, Italy, although otherwise recognised as facing a severe inflationary problem, was able to benefit significantly. The decision to take part in the EMS was explicitly motivated by a need to bring in external management in order to finally curtail inflation. Given that the bedrock of monetary legitimacy in Europe was unequivocally Germany, and in particular the Bundesbank, this is then effectively a transfer of low inflationary expectations from Germany to Italy.

The second major transfer that monetary union effectuated was the credibility of the Bundesbank. Naturally, this newfound credibility itself was critical in adjusting inflationary expectations, but it had significant and noteworthy effects beyond merely stabilising inflation. Given the issues surrounding debt management addressed earlier in this chapter, the improved credibility of the Banca D’Italia in managing its prodigious debt position was also significant.

The transition to a fixed exchange rate regime (such as the euro) might imply greater risks for countries with relatively high debt burdens, given that they might have less space to

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manoeuvre in defence of the fixed rate. The actual transition to the euro itself resolves this problem completely, because there is no peg left to attack. In addition to a range of other technical approaches that can be applied to minimise credit risk in the context of maintaining a currency peg, the credibility that underpins a well-functioning market for government debt issuance is critical, and transitioning to the euro system of central banks helped Italy improve the standing of the Banca D’Italia. Yields on Italian government debt fell throughout the transition towards monetary union, in many ways reflecting the increased competency of the Banca D’Italia (see Figure 2).

These gains are also in part the result of various structural benefits brought about through the financial integration of capital markets across Europe.\textsuperscript{52} The unification of fragmented markets across the continent, and the harmonisation of the new, unified market through common conventions across foreign exchange, bond, and money markets, further distributed credibility and trust across the eurozone, thereby mitigating country-specific risk. For relatively high-risk countries (i.e. Italy), this therefore resulted in a decrease in borrowing costs. This effect was clearly reflected in Italian sovereign debt yields, which fell decisively once it became clear that Italy was going to join the euro.

We should analyse these transfers from Germany to Italy in the context of domestic Italian politics, and in particular how participation in monetary union transferred political costs to Europe and mitigated domestic political risks. This effective manoeuvring through two level games allowed Italy to externalise the cost of orthodox monetary policy to the EU. Political parties in Italy can cite the ECB and the larger European governmental apparatus as the driving force behind unpopular decisions in order to arrive at improved policy outcomes without having to pay the political price. The political costs of this transfer, as a later section will explore in detail, are most likely to be experienced in terms of Italian public support for Europe, European integration, and specifically the euro itself.

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53 This argument in many ways also highlights a structural weakness of the euro: namely that domestic politicians have no incentive to fairly allocate both credit and blame between the national and European levels. Credit will likely be claimed at the national level, in order to leverage it for future elections, whereas blaming Europe when things go wrong has few immediate costs. The nature of elections to the European Parliament as second order national elections (see later section) ensures this strategy makes sense.
In addition to shifting negative political costs from domestic Italian political parties to Europe, the decision to adopt the euro also precluded Italian policy makers from setting monetary policy.\textsuperscript{54} As earlier sections in this chapter have argued, Italian policy making in this regard can broadly be characterised as ineffective and insufficiently disciplined. By outsourcing monetary policy to Europe, Italy no longer had to worry about the poor policy outcomes it had been generating on the domestic level. There would simply be no more monetary policy decisions to be made.

\textbf{Measuring Political Costs on the European Level}

The thesis that the construction of the euro effectively transferred the political costs of governance to Europe (in particular as they pertain to curtailing inflation and other such orthodox policies) requires further analysis. Intuitively, there are several places where we might see the impact of these costs. First, we might look at elections of the European Parliament. Second, we can analyse Eurobarometer data.

Elections to the European Parliament have an immediate handicap, however. Many scholars have noted that elections to the European Parliament are used by voters as a means of punishing or rewarding domestic politicians, specifically those in power.\textsuperscript{55} This appears to hold in the 2004 election to the European Parliament in Italy.\textsuperscript{56}


important given the introduction of euro coins and banknotes in 2002, meaning that voters would be most likely to start associating monetary issues with Brussels, rather than Rome, sometime after this transition. Although coins and banknotes entered wide circulation in 2002 (on the 1st of January), the euro itself was introduced on the 1st of January in 1999, after which all government debt was issued in euros. The period between 1999 and 2002 was marked by the gradual preparation for the eventual transition. Public perception is however only likely to have started to shift during 2002, as most preparations prior to 2002 were behind the scenes or in financial markets, which are generally removed from daily public awareness.

That being said, Figures 4 and 5 provide a graphical overview of all European Parliamentary elections from 1979 to 2014. The most notable change from previous elections in 2004 in Italy was the election, for the first time, of Eurosceptic parties. Whereas the broader Parliament had Eurosceptic MEPs since 1994, 2004 was the first time Italy sent any Eurosceptics to the European Parliament.\(^{57}\) It is also important to recognise that the later surge in Eurosceptics, particularly from Italy which, in 2014, sent 17 Eurosceptic MEPs (representing 23% of the Italian allocation of MEPs) to the Parliament, has been driven by the migrant crisis (see Figure 3).\(^{58}\) The data on elections from the European Parliament is then, at best, equivocal. Given that these elections primarily focus on national issues, and their small sample size, it seems imprudent to derive any conclusions on political costs from merely these data.

\(^{57}\) It is necessary to note that some non-inscrits MEPs from Italy prior to 2004 individually opposed EMU, however the election of a political party campaigning on the basis of Euroscepticism nonetheless marks a notable shift.\(^{58}\) Data on Italian elections has been converted such that each MEP is classified as a member of their political grouping, as opposed to their Italian party affiliation. The data does not take into account possible changes in allegiance, resignations etc. Given the relatively large number of MEPs in each parliament, this is unlikely to substantially alter the data.
Another, potentially more reliable source, is Eurobarometer polling data. These surveys, taken biannually across the EU, offer perhaps the most rigorous means of tracking the sentiment of the Italian public. As with elections to the European Parliament, the most salient point in time around which analysis should be centred is 2002, when euro notes and coins came into circulation across the eurozone.

*Figure 3: Non-EU Asylum Applications (Eurostat 2017)*
Figure 4 - European Parliament Elections by Political Grouping (European Parliament 2017)

Figure 5 - Italian European Parliament Elections by Political Grouping (European Parliament 2017)
There are several questions from the Eurobarometer that are applicable to this analysis. The first question addresses whether respondents believe decisions pertaining to the currency should be made on the national or the European level (see Figure 6). It effectively serves to measure support for the euro in place of national currencies.

![Figure 6-Support for European vs. Italian governance of monetary policy (Eurobarometer 2017)](image)

Figure 6-Support for European vs. Italian governance of monetary policy (Eurobarometer 2017)

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![Figure 7-Italian ratings of the EU (Eurobarometer 2017)](image)

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Notably, the key turning point appears to fall late in 2001, two months prior to the introduction of the euro (the second annual Eurobarometer falls in October). This trend, with a downward turn in views of the euro, but also the European Union more generally, holds in other questions as well. For example, Italian’s perspectives of the EU began trending downwards in late 2001 and early 2002 (see Figure 7). The proportion of respondents rating the EU as ‘Fairly Positive’ dropped from 54% in late 2001 to 46% in early 2005, whereas there is an upward trend in the proportion of respondents who responded with a rating of ‘neutral’.

This trend appears to also apply to overall support for Italian membership of the EU itself, though as part of a larger downward trend (see Figure 8). Though there is a momentary burst in support for EU membership in 2002, a relatively sharp downward trend continues from 1999 thereafter.

For all three of these questions, it is important to contextualise support for the EU and specifically the euro in terms of support for domestic Italian governments. The hypothesis is not
merely that the cost of monetary policy (and in particular orthodoxy) is absorbed on the European level, but also that is transferred away from domestic Italian politics.

Beginning roughly in 2000 and lasting until around 2005, Italian democracy appears to have enjoyed much higher approval ratings than before or after. Though it is difficult to isolate the impact of monetary policy and the euro from various other drivers of support, this nonetheless adds further evidence for the hypothesis, that political costs were transferred from Italy to Europe through the euro. The credibility of this thesis is significantly augmented by the findings of Giurlando’s surveys of Italian public opinion, which found that the Italian public saw monetary union as a means of bringing Italy up the level of Europe.  

Overall, any analysis of political costs and their distribution between the domestic Italian level and Europe is complicated by a range of factors. Isolating solely the impact of monetary policy on the perceptions of the Italian public is an enormous task, and beyond the

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scope of this chapter. Further, extricating the long-term effects of monetary policy from the enormous weight of the migrant crisis on Italian politics is a question beyond the scope of the analysis presented here. That being said, the Eurobarometer data, in combination with the data from elections to the European Parliament, provides at least initial evidence in support of the hypothesis that the political costs of implementing monetary policy were transferred from Italy to Europe, at least in the short term. The timing of downward trends in Figures 6, 7, and 8 is highly coincident with the introduction of the euro, and though other factors might explain some portion of these shifts in public perception, it is almost certain that the euro played at least a contributing role. Further analysis is necessary to thoroughly control for other related variables (such as GDP growth, wage growth, unemployment, etc.) and determine the specific effect of the introduction of the euro.

One final additional note in terms of the costs of the euro: Italians perceived the exchange rate between the lira and the euro as unfair, feeling for no less than two years after the handover that it had caused a spike in inflation. 60 Though the official rate was close to 2,000 lira to one euro, many prices were adjusted as if 1,000 lira were equivalent to one euro. 61 This is likely to have contributed to increasingly negative perceptions of the euro. However, this disparity in prices eventually subsided. This is then one concrete example of the political costs that were transferred to Europe by the creation of the euro, albeit only during the transitional period.

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Institutionalising to Mitigate German Monetary Control

Although in many ways Italy sought to benefit from and capture the best aspects of German monetary policy, in general Rome was very much opposed to outright German control over European monetary decisions. Rather, it was more the de facto status quo given Germany’s economic might that meant that Europe, including Italy, had no choice but to maintain close ties to Germany. In the repeated financial crises caused by American policy, Germany was not always unequivocally supportive of Italian interests. The 1992 financial crisis, which was discussed in an earlier section, is a good example of German priorities in this sense. The Bundesbank consistently demonstrated that, above and beyond any other consideration, German interests, and in particular the maintenance of low inflation, came first.

Given that, in a world without American leadership on this issue, Germany effectively assumed control over various critical interconnected financial markets, it was in Italy’s interest to push for an institutionalised response on the European level. This response, in the form of the EMS and later the euro, retained significant German influence over monetary policy but critically relegated Germany to merely one seat at the table. The metaphorical significance of this arrangement ensured that all parties had nominally equal amounts of influence over monetary policy, through their equitable representation on the Governing Council. As such,

decisions pertaining to monetary policy would now be announced as coming from the ECB, rather than the Bundesbank. The experience of the EMS also positively informed this goal. Although Germany certainly exerted the most influence over the direction of the EMS, it was not completely dominant, despite its overweight position. The other members of the EMS were able to influence German policy significantly. Given that the euro was institutionally even more integrated than the EMS was, the Italians were therefore quite reasonable in aiming to use the institutionalisation of the euro as a mechanism of blunting German influence.

The Bundesbank nonetheless was able to extract significant concessions during the design of the ECB that were intended to ensure its independence and instil as much rigorous orthodoxy as possible. The Italians, along with the rest of Europe, were willing to accept these demands in exchange for the significant prize of German acceptance of the euro and the corresponding decrease in the perceived and real power of the German Bundesbank over monetary policy across Europe.

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Conclusion

The purpose of this chapter is to highlight several ways in which Italy acted in its rational, economic, self-interest in adopting the euro.\textsuperscript{68} By outsourcing monetary policy to the European level, Italy was able to import German credibility and low inflation, killing two birds with one stone. This politically astute manoeuvre satisfied economic demands from Italian companies by guaranteeing unfettered access to the European market and the complete removal of foreign exchange risk within Europe. By finally getting inflation under control, Italy was able to improve its standing in capital markets, both domestic and foreign. Yields on Italian government debt fell as a result, strengthening the fiscal position. Though Italy had tightened the external constraint imposed by monetary cooperation, in exchange it significantly improved policy making outcomes.

The costs of this (relatively) orthodox monetary policy were not absorbed by domestic Italian actors. Instead, as a result of the institutionalisation of European control over monetary policy, Europe absorbed the political costs. This is reflected in data from the European Elections and, most reliably, in Eurobarometer polling data from the period. Although the average Italian citizen likely had little awareness of the actual functioning of the ECB, the replacement of the lira with new euro coins and banknotes in 2002 meant that everyone, without fail, was aware of the transition. The new banknotes and coins were both covered in European symbols, proudly proclaiming their origin as belonging to all of Europe as opposed to merely Italy.

\textsuperscript{68} This is not meant to conclude (or prove) that Italy made the right decision in adopting the euro. Rather, it is meant to highlight ways in which adopting the euro served Italy’s interests. Other concerns are relevant as well, but beyond the scope of this chapter.
Germany: Maintaining Orthodoxy Without Creating the Fourth Reich

Germany’s position in Europe after the Second World War was characterised by the awkward tension between economic dominance and the societal need to adopt a cooperative, non-assertive position.\(^{69}\) Economically, Germany became the powerhouse of Europe through reunification and the gradual recovery of German industry from the war.\(^{70}\) The Deutschmark, much beloved by the Germans, was the second most popular reserve currency in the world, behind only the dollar.\(^{71}\) However, politically the situation was much tenser. Following the humiliating national shame of the Third Reich, the German political establishment was loathe to create even the slightest impression of assertiveness or dominance.\(^{72}\) Germany’s economic dominance manifested itself, amongst other places, in foreign exchange markets, as the financial crisis of 1992 highlights.\(^{73}\) Unfortunately for the Germans, the functioning of these markets strongly reinforced the impression of German dominance, at times at great cost to other states.\(^{74}\) This meant that German politicians had a strong interest in developing an institutionalised solution for foreign exchange management in Europe that effectively deflected

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\(^{69}\) For the sake of simplicity, when I refer to Germany I refer both to West Germany and unified Germany. In this particular context this simplification is warranted because East Germany did not substantially alter the monetary policy preferences of Germany (in particular those of the Bundesbank) nor the economic preferences of dominant interest groups (such as industry, which was concentrated in the Ruhr regardless). That being said reunification itself did have material impact on the formation of monetary union, as is addressed later on.


\(^{73}\) See later section on German positioning in Europe post Bretton Woods.

political costs from Germany whilst still serving key economic interests. These political costs took the form of both reputational damage and a serious threat to the ability of Europe to cooperate on key monetary policy issues.

German economic interests in this regard are relatively clear. The Bundesbank was legendary for its orthodox stance on inflation and monetary policy in general, and functioned as a key guarantor of the respected position of the deutschmark internationally.\(^\text{75}\) German industry, famed globally for its expertise and in many ways a byword for quality, was looking for greater access to foreign markets for exports.\(^\text{76}\) Conceptually, the degree of foreign exposure economic actors face plays a role in determining their preferences as regards foreign exchange.\(^\text{77}\) The greater the exposure to foreign exchange rate risk, the actor should display a greater preference for stability in the foreign exchange regime, in order to mitigate the negative impact of foreign exchange rate risk on investment decisions, margins, and their supply chain.\(^\text{78}\)

Not only does foreign exchange rate risk matter, but German industry was also keenly aware of relative positioning in Europe. A weak franc and lira undermined the competitiveness of German goods, and so any solution that removed the ability of the French and Italians to


\(^{77}\) Joesten, Joachim. "German Industry Conquers the World." New Germany Reports, October 1957: 3-17, 3.

\(^{78}\) See the section on the positioning of German industry for more detail on this conceptual framework and its implications in this context.
devalue was a win. In the absence of such controls (like a fixed exchange rate), the deutschmark would be expected to appreciate in value, thereby hurting German exports, due to the strong current account balance and persistent foreign inflows. German industry’s bold charge into international expansion after World War II generated strong domestic pressure in favour of a foreign exchange rate regime that prioritised stability.

This powerful economic motivation was coupled with the well-established preference of the Bundesbank for a low inflationary environment. The disconnect between the Bundesbank and the rest of Europe on inflation caused significant friction in European politics. At various points, including the 1992 financial crisis, the Bundesbank used its dominant position to decisively act in the German national interest, at the expense of the rest of Europe.\(^79\) This created immense friction within Europe, as the economic context meant that European governments and central banks had no choice but to cooperate on monetary policy. The severity of the costs incurred by Germany for its perceived dominance is demonstrated by the successful lobbying by the French for lower German rates in 1992, on the side-lines of the IMF-World Bank meetings in Washington.\(^80\)

The French delegation, led by Jean-Claude Trichet, needed the Germans to act in order to save the franc from being pushed out of the ERM. The Germans had earlier refused to step in to save the pound and the lira from crashing out the EMS, but were cowed when the French

invoked the spectre of the second World War and the historical weight of Franco-German cooperation. The Bundesbank, otherwise one of the most inflexible and famously stubborn institutions, folded. They jointly issued a statement in support of the parity between the franc and the deutschmark, in addition to a few other measures to support French participation in the EMS. This example, reminiscent of the 1978 meeting between Schmidt and Emminger, serves to underscore just how serious the cost of perceived German overbearance was. With their national guilt hanging over them, the Germans would go to great lengths to avoid incurring further reprimands from the international community for asserting their self-interest.

The solution was to address the flaws in the EMS by transitioning to a more thoroughly institutionalised system that would have sufficient credibility and political commitment to ensure its stability and longevity. For the Germans, the main benefit of this approach was that they could retain their strong influence over monetary policy across Europe (in line with the powerful position of the Bundesbank), but now under the guise of politically favourable pan-European sentiment. The ECB, not the Bundesbank, would now be responsible for unpopular policy decisions that, in the eyes of the Germans, were necessary. In order to ensure that the ECB would preserve the orthodoxy of German monetary policy, the Germans leveraged both

81 Ibid, 92.
82 The famous meeting, itself the focus of several books, between Schmidt (then Chancellor) and Emminger (the Governor of the Bundesbank) is in many ways the typical example of Franco-German cooperation and the shame of the second world war being leveraged to pressure the Bundesbank into cooperating.
84 The weakness of the EMS in this regard was that members had to actively defend the necessary exchange rate, an incredibly costly exercise, both in terms of economic and political capital.
their strong economic position (in terms of trade and balance of payments, and use the relatively extreme positioning of the Bundesbank to manoeuvre through two-level games and influence the outcome of the Maastricht treaty.\textsuperscript{85} This approach was, however, complicated by concerns about German reunification, most significantly from the French. A unified Germany would combine the economic might of the west with the labour force of the east, and together risk tipping the balance of power in Europe. The French, ever fearful of losing their position within Europe, demanded the most valuable concession they could: the deutschmark. The Germans, in order to unify their homeland and capture the economic benefits of monetary union and reunification, accepted the deal.\textsuperscript{86}

Throughout this political manoeuvring it is important to keep in mind that, although the Germans were operating in the political arena during negotiations over the future of monetary union, their key driving motivations were economic. The Bundesbank’s preference for low-inflation and monetary orthodoxy, despite its political implications, is derived from a strongly constituted view of what is best for the German economy.\textsuperscript{87} The costs of German dominance over European foreign exchange rates, though ultimately felt in the political sphere, were generated by the strongly positive balance of payments position of the German economy.\textsuperscript{88}

87 Ibid, 89.
That position is in turn generated by the globally recognised strength of German industry, which is largely export oriented.\textsuperscript{89} German industry sought to benefit from monetary union not only through the removal of foreign exchange rate risk in trade with the rest of Europe, but also as a means of avoiding the harmful effects of the appreciation of the deutschmark. Fixing exchange rates meant that European competitors would not be able to competitively devalue.

This is the key value add of this chapter to the existing literature: to highlight the extent to which Germany, during the process of negotiating and forming monetary union, was motivated by rational economic self-interest. In hindsight it is clear that the euro (and European integration more broadly) have delivered enormous economic benefits to Germany, but some of the most prominent scholars of the topic, including Eichengreen and Frieden, focus instead on the political motivations for pursuing monetary union. Additionally, the existing literature does not recognise that key German actors were aware of these economic benefits at the time, which this chapter will also seek to highlight.

Key to recognising this economic self-interest are the concessions the Germans negotiated in the structure of the ECB, thereby ensuring the continuity of orthodox monetary policy, and the relative positioning of the deutschmark. The adoption of the euro effectively meant that Germany was spared the appreciation of the deutschmark that the current account would otherwise have brought on. With the euro, the German current account surplus is absorbed by persistent current account deficits in other euro countries, thereby ensuring that the euro is weaker than the deutschmark would be, delivering competitive gains to German

\textsuperscript{89} Joesten, Joachim. “German Industry Conquers the World.” New Germany Reports, October 1957: 3-17, 3.
exporters. As the rest of this chapter will seek to explore and contextualise, the Germans were aware of both points while deciding whether to join monetary union, a point which the existing literature does not recognise.

Foreign Exchange in Europe Post Bretton Woods: The German Experience

Although to a lesser extent than Italian monetary policy, Germany monetary policy is also bound within the dominant global order. From 1944 to 1971, Germany took part in the Bretton Woods system.\(^90\) This system, which effectively dictated that the world follow the US in monetary policy, was hampered by the unwillingness of the US government to prioritise the needs of other parties over its own.\(^91\) One of the first catalysts for the shift from a global, effectively American approach to mitigating foreign exchange risk towards a European approach came in 1968, when fears that the US might devalue the dollar set off a chain reaction throughout Europe.\(^92\) The deutschmark moved first, by appreciating relative to the dollar. This created tension between France and Germany, who were otherwise committed to maintaining parity. Market forces then dictated that France devalue, which only exacerbated German concerns about inflation, pushing the Germans to appreciate.

Willy Brandt, who in 1969 was Chancellor, moved to resolve the issue.\(^93\) His preferred method of addressing the tension with the French was to deepen the European community by moving towards full monetary union. The road to Maastricht was still long, and it would be

\(^{92}\) Ibid, 73.
\(^{93}\) Ibid, 74.
quite a few years before his idea, which echoed the goals of many before him, came to fruition, but the Americans kept nudging the Europeans in the direction of a European solution, largely independent of the US.\textsuperscript{94} As much as the Americans continued to demonstrate that they would prioritise domestic concerns over European needs, the Germans were in many ways constrained by the national shame of the second world war, and were hesitant to take any decisive action.\textsuperscript{95} The final collapse of Bretton Woods was triggered by Nixon’s decision to unilaterally end the convertibility of the dollar to gold in 1971, a move which certainly gained him no friends in Europe.

The next global iteration of a monetary policy regime was the so-called “Smithsonian Agreement”, which was created in 1971, the year Bretton Woods finally collapsed.\textsuperscript{96} Fundamentally, this new system was no different from the one that preceded it. In 1972 and 1973 the US allowed the dollar to devalue significantly, thereby inflicting significant pain on Europe.\textsuperscript{97} The structure of the agreement, with a central peg to the dollar, meant that European currencies had no choice but to follow the movement of the greenback within their narrowly prescribed ±2.25% bands. Things came to a head in 1973 when the dollar moved so suddenly and significantly that Italy had no choice but to abandon the system entirely.\textsuperscript{98}

97 Ibid, 77-78.
Although aided by strong cooperation across the board, the participants in the system lacked the will to sacrifice the necessary political and economic capital to preserve it.

As Europe was forced to pivot away from US leadership in foreign exchange, the deutschmark came to function as the dominant European currency. This brought both benefits and costs to the Germans. The benefits were primarily from the position of the deutschmark as the regional reserve currency, and meant lower yields, greater liquidity, etc. The costs however, far outweighed the benefits. Given the German fear of taking on a dominant position in Europe, the deutschmark suddenly came to play far too dominant of a role in Europe. This meant that the policies of the Bundesbank, often significantly divorced from monetary policy in the rest of Europe, suddenly came to carry much more weight in European affairs. This created significant tensions across Europe.

One example of this is the financial crisis of 1992, which spread from Denmark across Europe. The Danes triggered the crisis by voting down the Maastricht treaty, which brought the weaknesses inherent in the design of the EMS to the forefront for investors, many of whom responded by targeting weak currencies. High rates of inflation in the UK and Italy marked

them as the weakest members of the EMS, triggering capital outflows to Germany. This only exacerbated the problem by causing the overshoot of medium-term monetary supply targets in Germany, pushing the Bundesbank to raise rates.\textsuperscript{103} This only increased the contrast between Italy and the UK on the one hand, and Germany on the other, further increasing flows. Eventually, the UK and Italy had no choice but to abandon the ERM and float their currencies.

Though it came relatively late in the process of monetary integration and was eventually overcome in large part through cyclical improvements in economic conditions, this crisis reflects the political tensions created by the German position in Europe.\textsuperscript{104} The reputational damage incurred was well targeted to reopen the wounds inflicted by the shame of war, and a political cost German politicians were loath to continue bearing for much longer.

With the unparalleled national embarrassment of two back-to-back world wars fresh in the German collective consciousness, this cost was greater than what Germany could bear.\textsuperscript{105} Without the option of deferring leadership to the US, Germany had to look closer to home for an alternative option. With time, the Germans came to see the transition to the euro as the ideal way of both escaping the political costs of their dominance and as a means of exporting their preference for orthodox, disciplined monetary policy the rest of Europe.\textsuperscript{106}

\textsuperscript{106} As modern history shows us, the effect of the euro is merely relative, and was ultimately modulated by a range of other factors, including political pressures to expand and insufficient independent checks.
Escaping the Shadow of the US

Coming out of the shadow of national socialism and the guilt of the second world war, Germany entered the second half of the 20th century focused on being an obedient ally of the US. 107 This played into German participation in US management of global foreign exchange policies through first Bretton Woods and then the Smithsonian Agreement. When Brandt pushed for the euro in 1969, one of the barriers he came up against at the time was that Germany was still committed to its relationship with the US and unwilling to take too dominant a position, for fear of being rebuked. 108 However, this started to change with US unilateralism under Nixon. 109 Though the world was still committed to Bretton Woods, US action was increasing the costs of maintaining the system. 110 In 1971 Nixon brought the issue to a head by terminating the convertibility of the dollar to gold, thereby pulling the proverbial rug out from under the entire regime. 111 Nixon’s decision, clearly made without much regard to the interests of Europe, forced Germany to recognise that, though the past remained a painfully shameful memory, they could no longer afford to blindly accept the US led status quo in monetary policy. This demanded that Germany, albeit gradually and acting through the politically palatable

109 Ibid.
framework of Europe, find an alternative solution to managing foreign exchange risk that didn’t depend on the US.

The last attempt at US-led international cooperation on foreign exchange came later that same year, with the creation of the Smithsonian agreement. Nixon and Pompidou, a pragmatic Gaullist, had negotiated that the dollar be devalued by 7.9% in order to begin stabilising the international system, which was still reeling from the shock of US withdrawal from Bretton Woods.\textsuperscript{112} In order to facilitate the participation of other states, particularly those with weaker currencies, it then became necessary for Germany to significantly revalue the deutschmark. This would hit German exporters, but, in the last act of an obedient ally, Germany revalued the deutschmark no less than 14%.\textsuperscript{113} Ultimately, the Smithsonian “snake in the tunnel agreement” did not last long, as the EMS began operating in 1979.\textsuperscript{114} Nonetheless, it marked the end of German acceptance of unilateral leadership (in this regard), and was the beginning of serious attempts to devise a European solution to the problem of managing foreign exchange rate risk. The costs of following the US had simply become too great, even if the embarrassment of the second world war demanded non-assertive German posturing.

This sequence of events was in many ways the catalyst for the Werner report, which was published in 1970.\textsuperscript{115} Pierre Werner, who at the time was Luxembourg’s Prime Minister and Finance Minister, presented the plan at a European summit in The Hague. The plan was

\textsuperscript{113} Ibid, 77.
ambitious, calling for a fixed rate foreign exchange regime, a federal system of central banks, and extensive fiscal transfers across Europe. Though bold in vision, the plan failed to outline a path towards transition, or take into account the political feasibility of its proposals.\textsuperscript{116}

Nonetheless, the Werner report was the first in several iterative attempts to develop what ultimately became the euro. Subsequent German chancellors, notably including Helmut Schmidt in 1978 and Helmut Kohl in 1982, were much more openly pro-European and willing to work outside of the framework set forth by the US.\textsuperscript{117} Schmidt, in the aforementioned meeting with Emminger (then Chancellor of the Bundesbank) specifically mentioned: “if it could make us a bit more independent of dollar fluctuations [...] that would certainly be welcome.”\textsuperscript{118}

Germany was finally ready to move towards a European solution and away from one that depended on the US.

\textbf{Industrie Über Alles}

The strong, relatively united position of German industry has a strong impact on the external preferences of Germany in terms of foreign exchange rate management and was one of the key drivers of German participation in monetary union. Conceptually, we can understand that the more an actor is exposed to international finance (i.e. through longer contracts, more cross-border financing, etc.), the greater their preference is for stability in the foreign exchange

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\textsuperscript{116} Even today the Germans are still strongly opposed to any kind of fiscal transfer across Europe. \\
\textsuperscript{118} Bundesbank Archive. “Bundesbank Council meeting with Chancellor Schmidt (assurances on operation of EMS) [declassified 2008].” Margaret Thatcher Foundation. 30 November 1978. \\
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regime. Exporters naturally fall into this category, as they often rely on the provision of credit and long-term international contracts. The increasing complexity of trade occurring in supply chains, as opposed to trade in finished goods, only increases the extent to which producers of complex goods depend on stable international environments for their business.\footnote{119 Frieden, Jeffry A. Currency Politics. Princeton: Princeton University Press, 2015, 19, 22, 23, 171.}

Within exporters, one additional nuance is the degree of exchange rate pass through in a particular industry.\footnote{120 Derviş, Kemal, Joshua P. Meltz, and Karim Foda. “Value-Added Trade and Its Implications for International Trade Policy.” Brookings. 2 April 2013. https://www.brookings.edu/opinions/value-added-trade-and-its-implications-for-international-trade-policy/ (accessed November 25, 2017).} In this context, pass through is defined as “the extent to which changes in the exchange rate are transmitted to domestic prices.”\footnote{121 Ibid.} Industries trading in raw goods, for example, see high rates of pass through.\footnote{122 Ibid, 30.} Conversely, for producers of more complex goods, pass through is relatively limited. This is primarily a function of the intricacy of global supplies chains in the production of goods. Each intermediary has its own set of contractual agreements, and changes in foreign exchange rates would have to filter through each layer of parties in order to reach the end consumer. This leaves the industry as a whole with much greater exposure to exchange rate risk, due to lower pass through.\footnote{123 Ibid, 35.} For a company selling grain, it simply multiplies the world price of grain by the local exchange rate and adds a competitive mark-up to cover costs. Given the enormous impact of foreign exchange rate risk on trade, the simplest and most effective solution is to adopt a fixed rate regime.\footnote{124 Ibid, 171.} German industry is then a perfect example of limited pass through and the implications thereof for preferences in

\begin{thebibliography}{99}
    \bibitem{121} Ibid.
    \bibitem{122} Ibid, 30.
    \bibitem{123} Ibid, 35.
    \bibitem{124} Ibid, 171.
    \bibitem{125} Ibid, 45.
\end{thebibliography}
foreign exchange rate policy. Highly specialised, and with effective lobbying capacity on the national level thanks to a generally cooperative relationship between industry, unions, and the government, Germany industry was a key proponent of monetary union.\textsuperscript{126}

Some German export oriented industry leaders believed that the new euro would be weaker than the deutschmark, thereby effectively improving their competitive positioning in international trade.\textsuperscript{127} Assuming that currencies are often priced on the basis of the perceived relative riskiness of the relevant government, a weaker euro would make sense given the incorporation of risk from Italy, Spain, Greece, and other peripheral nations.\textsuperscript{128} On average, the combined sovereignty of all of the nation states that collectively underwrite the euro (i.e. the eurozone) is riskier than the sole German sovereignty that underpinned the deutschmark. This would then alleviate the pressure on the deutschmark to appreciate caused by the persistently strong current account, effectively offering German exporters a more competitive international position. This point is absolutely critical, as German industry expended significant effort on lobbying to prevent revaluations of the deutschmark.\textsuperscript{129} This pressure, to avoid an overly strong deutschmark, was exacerbated by competition with firms in Italy and France, amongst others, which benefitted from the relatively weak lira and franc, respectively. The euro then not only

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mitigated the pressure to prevent the revaluation of the deutschmark, but also foreclosed the possibility of competitive devaluation in the rest of Europe.

Additionally, like in the Italian case, the positive record of the EEC also factored into support for the euro from German industry. The creation of the EEC was one of the key driving factors behind the cost of trade within Europe decreasing significantly during its implementation.130 This decrease in the cost of trade was critical in causing a fourfold increase in trade within the EEC.131 This was recognised by many German politicians, including Schmidt in 1978 in a key meeting of the Bundesbank on the EMS when he argued that: “[t]he Common Market [...] made possible the huge unleashing of economic potential that has taken place in the last twenty years.”132 Additionally, the gradual financial integration that occurred in the 1980s contributed to increasing capital mobility across Europe.133 Financial integration, and the accompanying current account imbalances, necessarily requires the management of foreign exchange rate risk.134 The euro, and the corresponding commitments to the free movement of

Firms could privately manage foreign exchange risk through forward contracts and other financial derivatives, but this is only possible in liquid and deep financial markets, can introduce new risks that require financial expertise to manage, and can be expensive. For many of the smaller European currencies, market conditions were simply not sufficiently conducive for this to be an option.
capital and people, are in many ways then the most effective and complete commitment to meeting these expectations.\textsuperscript{135} German politicians, like Helmut Kohl, understood the benefits a single, unified market for goods and services across Europe would bring to Germany.\textsuperscript{136} He worked to deliver the single market, and came to realise that, in order to achieve this goal, he had to back monetary union as well. The amount of intra-European trade envisioned by a truly unified market was simply not possible if every transaction required participants to manage foreign exchange rate risk.

The argument here is conceptualised in the policy trilemma Mundell and Frieden, amongst others, have presented between financial integration, a fixed exchange rate, and monetary independence.\textsuperscript{137} Each nation can select two priorities, but it is not possible to attain all three. Since, financial integration in Europe was a given, the remaining choice was then between a fixed rate and monetary independence.\textsuperscript{138} The costs and benefits of this trade off, between stability in foreign exchange rates and the ability to set monetary policy on the national level, were modulated in Germany by several factors.\textsuperscript{139} Firstly, the cost of a fixed rate regime would be the loss of monetary independence, which one might assume to be relatively high given the prestige of the Bundesbank. However, the Bundesbank was able to extract significant concessions in the design of the ECB that significantly mitigate this concern, as will be discussed below. Additionally, the goal of peripheral member states like Italy was to benefit

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\textsuperscript{136} Ibid, 86.
\textsuperscript{138} Ibid.
The primary cause of this conclusion was the EEC and the financial integration in augured in the 1980s.
\textsuperscript{139} For the sake of simplicity, we can regard the euro as the most extreme version of a fixed rate regime.
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from the credibility of the Bundesbank, not destroy it. Secondly, the benefits of a fixed rate regime were expected to be quite significant for Germany, as they would improve the ability of German firms to access other markets. So, on net, Germany was able to retain the benefits of credible, orthodox monetary policy (by transferring it to the ECB) and gain the benefits of a fixed exchange rate.\textsuperscript{140} This transfer was critically important in ensuring that key German interest groups supported the euro and in preserving the credibility of German monetary policy.

One goal of the single market for Germany was of course to increase foreign market access for its exporters.\textsuperscript{141} Given the highly specialised and productive state of German industry, the expectation was that German firms would gain increased market share over competitors. Additionally, the implications of several structural elements of the euro were also positive for German firms.\textsuperscript{142} Increased competition across Europe should result in depressed wage growth, both in Germany and abroad. The effect should be particularly strong in Germany however, where wages were higher than in many peripheral economies. Secondly, the increased size of the European market was expected to catalyse a range of improvements in capital markets, thereby improving liquidity, competition, and pricing for firms.\textsuperscript{143} All of these

\textsuperscript{140} In hindsight it is possible to question the extent to which the credibility of the Bundesbank transferred to the ECB. Programmes like QE have certainly defined the ECB as a forward thinking, rather than orthodox, central bank. However, questions such as these were unforeseeable before the turn of the century, so for the purposes of this paper it is sufficient to recognise that the Germans extracted significant concessions in terms of the structure of the ECB in order to mitigate concerns about its setting of monetary policy.
\textsuperscript{142} Ibid.
\textsuperscript{143} Ibid.
factors together meant that monetary union was strongly in the interest of German industry, and German politicians like Kohl worked to bring it to fruition.

Not all Germans believe in God, but they all believe in the Bundesbank

German positioning within Europe was equally problematised and strengthened by one key concern: inflation. Where other European states, notably including Italy and France, were much less averse to inflation, Germany, and in particular the Bundesbank, was diametrically opposed to any action that might spark inflation.144 Whereas the Bundesbank was the patron saint of low inflation, France was seen as suffering from a chronically high rate of inflation and lacked the fiscal discipline necessary to address it. The preference for low inflation was not only on the part of the Bundesbank, but also widely held amongst the German people, who revered their central bank.145 The Bundesbank’s relatively extreme positioning on this issue was effectively leveraged by Germany during negotiations on the shape of monetary union.146 Given that other negotiating partners understood the clout of the Bundesbank, both domestically and internationally, Germany was able use this to influence the institutional design of the ECB and the goals of monetary union.

The most clearly visible German victories came, as if often the case with European politics, in Franco-German negotiations. Although the Germans themselves also saw clear benefits from the euro, the French were perhaps some its most ardent supporters. By playing up concerns about potential spill over effects in inflation from France to Germany, the Germans were able to reach a broad compromise with the French and other key negotiating partners: the Germans would take part in monetary union, but in exchange the project had to target monetary discipline and orthodoxy. These goals were not merely about exporting German economic views to the rest of the continent, they were also seen as being necessary to appease the German concern at home from the perceived threat of contagion from the undisciplined south, particularly from France and Italy.

The target for these goals naturally became the ECB. The Germans were able to ensure that not only was this new central bank located in Frankfurt, where the Germans hoped proximity to the Bundesbank would be an positive influence, but they also drafted the statute of the ECB. The federal structure of the ECB is the direct result of German efforts to model it off the Bundesbank. Critically, the ECB would have only a limited ability to finance the deficits of governments, in order to avoid its exploitation by short sighted politicians. The final and perhaps most significant German victories in this regard were the requirements placed on countries wishing to join the euro. Budget deficits were to be capped at a mere 3% of GDP, and

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151 One is reminded of the Italian precedent in this regard.
government debts could not exceed 60%. This mitigated concerns about the cost of losing the beloved deutschmark, and reinforced the gains of monetary union by expanding German orthodoxy.

Through leveraging the credibility and relatively extreme positioning of the Bundesbank, Germany was able to ensure that the euro, and in particular the ECB, were modelled off their own system and perpetuated key elements of the German approach to avoiding high inflation at all costs.

Conclusion

German participation in monetary union was driven by a desire to both mitigate the political costs of the dominant position of the deutschmark and advance the economic interests of German industry. By institutionalising a stable, orthodox, and federalised monetary policy management regime in the form of euro system, Germany was able to protect its all-important commitment to low inflation while also benefiting from the positive image of pan-European branding and the improved market access for German firms. Without reliable US leadership in the field of foreign exchange, Europe had to go it alone, and though the Germans balked at shouldering that burden entirely themselves, they nonetheless were able to work with the rest of Europe to develop a solution that satisfied all involved parties.

152 Ibid, 89.

It is important to note that Italy never fulfilled these requirements entirely. This was clearly a result of political priorities being emphasises over the textual details of the Maastricht treaty. Nonetheless, the significance of these austere rules stands, as their bite is felt even today across Europe.
Crucially, the euro was expected at the time by German leaders to deliver tangible economic benefits through the continuation of orthodox monetary policy, its lack of appreciation relative to the likely path of the deutschmark, and the institutional prevention of competitive devaluation elsewhere in Europe. This point is crucial, as the recognition that the Germans were aware of the economic benefits of monetary union during the drafting process substantively alters our interpretation of the process. Prominent scholars on the topic instead seem to imply that the economic benefits of the euro only became apparent after the fact.

The path towards monetary union came during the early phases of German reckoning with the national shame and guilt of the second world war, which significantly slowed the process. Ultimately however, the reality of US unilateralism meant that the Germans had no choice but to look elsewhere, and they were ultimately able to find an amendable solution that included reunification, another central policy priority. Economic priorities, channelled through the complicated realities of politics, were one central part of the German decision to take part in monetary union.
Conclusion

Italy and Germany, as two of the largest economies in Europe, play a key role in the ongoing existence of the euro. This thesis has sought to augment the existing understanding of the factors that drove both countries to participate in the creation of monetary union, focusing in doing so on economic rationales that have been underappreciated in the existing literature.

The Italian decision to participate in monetary union was motivated by a strong desire to finally curtail persistently high inflation and improve generally weak and ineffective monetary policy making. The creation of the ECB effectively outsourced monetary policy to Europe, thereby sidestepping the political obstacles that had weighed down policy making in the past. By outsourcing monetary policy to the European level, Italy was able to import German credibility and low inflation. This politically astute manoeuvre brought economic benefits by guaranteeing unhindered access to the European market and the complete removal of foreign exchange risk within Europe. Additionally, by finally getting inflation under control, Italy was able to improve its standing in capital markets, both domestic and foreign. Though Italy tightened the external constraint imposed by monetary cooperation, in exchange it significantly improved policy making outcomes. The costs of this newly orthodox monetary policy were not absorbed by domestic Italian political actors. Instead, as a result of the institutionalisation of European control over monetary policy, Europe absorbed the political costs. This is reflected in data from the European Elections and, most reliably, in Eurobarometer polling data from the period.
German participation in monetary union was driven by both a desire to mitigate the political costs of the hegemonic position of the deutschmark and to advance the economic interests of German industry. By institutionalising a stable, orthodox, and federalised monetary policy management regime in the euro system, Germany was able to protect its all-important commitment to maintaining low inflation while also benefiting from the positive image of pan-European branding and improved market access for German firms. Crucially, the euro was expected at the time by German leaders to deliver tangible economic benefits through the continuation of orthodox monetary policy, its lack of appreciation relative to the likely path of the deutschmark, and the institutional prevention of competitive devaluations elsewhere in Europe. Economic priorities, channelled through the complicated realities of politics, were one central part of the German decision to take part in monetary union.

In both cases, the analysis presented here is meant to augment existing work on the motivations behind the creation of the euro. The new contribution of this work is to highlight the transfer of political costs from Italy to Europe through the ECB, and to emphasise the extent to which the economic benefits of the euro were understood by Germany at the time, rather than merely becoming apparent after the fact.
### European Parliament Elections by Political Grouping

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### Italian European Parliament Elections by Political Grouping

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Bibliography


Joesten, Joachim. “German Industry Conquers the World.” New Germany Reports, October 1957: 3-17.


