Creating Legitimacy in EMU

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"Perhaps [it is] a situation with which we have to live"
-Otmar Issing, European Central Bank Chief Economist, referring to Europe's low economic growth[1]

[1] Financial Times, 6 May 2006

The above quote demonstrates how expectations surrounding European monetary integration have been scaled back since the introduction of the euro. European monetary union (EMU) was one of the most ambitious projects ever taken on by the European Union. The successful transition from national currencies to the euro, however, has been overshadowed by criticisms ranging from its failure to spur growth to its contribution to the rejection of the constitutional referendum in the Netherlands. While one can attach varying weights of significance and validity to such criticisms, they illustrate a disconnect between the expectations created by EMU and the actual implementation of policy post-Maastricht. Instead of reinvigorating European integration, monetary union has been blamed for many of its failures. Why and how did EMU become the EU's scapegoat?

In this article, I argue that much of the discontent surrounding monetary union ultimately stems from a lack of legitimacy that has manifested itself in inconsistent policies and an accountability structure that made scapegoating the preferred method of dealing with problems encountered in EMU's implementation. This reflects the problems of legitimacy which the EU faces more generally and needs to be addressed if the EU is to tackle major challenges in the future, including developing the capacity to assume a leadership position in international monetary forums. EMU's legitimacy was based on the technocratic expertise of economists and central bankers, but the transference of power to supranational institutions was incomplete. A shared sovereignty emerged in which both the independent European Central Bank along with national governments created European economic policy. While the contrasting incentives of these sets of actors (supranational and national) need not necessarily have caused problems, the poor delineation of accountability for policy contributed to the penchant for scapegoating and blame-shifting rather than collectively assuming responsibility. The Eurozone's governments and institutions have become competitive rather than cooperative, thus contributing to the malaise of integration more generally. EMU has succeeded in its nominative goal of achieving price stability, but such victories concern economists and central bankers more than the general public, which expected stronger economic growth and competitiveness. The widespread perception that EMU has not contributed to an economically dynamic Eurozone means that EMU has been found wanting in both input legitimacy (popular support resting on shared values) and output legitimacy (superior economic outcomes than could be achieved without delegation of policy) as described by Scharpf (1999). As one observer writes, "In the post-referendum debate in June (2005), the idea that emerged was that voters in France and the Netherlands had primarily expressed dissatisfaction with Europe's economic performance and that growth was needed to restore the European Union's legitimacy" (Pisani-Ferry, FT 8/31/2005).

The first part of this article looks at the bases of the EU's legitimacy in general and EMU's legitimacy in particular. Much of the EU's legitimacy rests on output legitimacy, and the expected output of EMU was price stability and greater competitiveness, based on economic theories of the importance of price stability and its role in enhancing credibility and promoting investment. These were institutionalized in the highly independent European Central Bank, the Maastricht Treaty convergence criteria and the Stability and Growth Pact. However, despite the convergence towards neoliberal economic policies among European countries in the 1980s and 1990s, the institutions and policies adopted evoked controversy among academics and politicians, and these initial disagreements later spilled over into the public debate over EMU's implementation at the national level.

The subsequent section examines how EMU's legitimacy suffered as a result of expectations surrounding EMU were not fulfilled during its initial years of operation. In particular, the economic slowdown in the larger countries that contributed to the return of more politicized monetary policymaking and did a considerable amount of damage as a primary motivation for monetary integration was the expectation of higher economic growth.

The next section looks at the politicization of EMU in more detail. In particular the implementation (and lack thereof) of the Stability and Growth Pact and its reform in 2005 demonstrated how the management of EMU had become a competition between EU institutions as well as participating member states. The most damaging one is that between the ECB and the Eurogroup. I offer three interrelated explanations to explain this rift: the differing incentives of the two institutions, the open-ended institutional design of monetary union, and the struggle for legitimacy that both face. This is followed by proposals for enhancing the legitimacy of EMU through market sanctioning, the European Parliament, the Commission and finally through political union. The final section concludes.

1. Institutionalizing and Legitimizing EMU

The legitimacy of the European Union becomes increasingly salient as its policies become further reaching and impinge on the lives of its citizens. While some have argued that EU policy in general, and monetary policy in particular, need not live up to some idealized standard of popular support and democratic legitimacy (Jones 2002; Moravcsik 2002), arguments of the equivalency of delegation at the domestic level to delegation at the EU level remain problematic. Delegation occurs at the domestic level for reasons of efficiency and expertise, thus legitimizing the delegation of policy on the expectation of superior outcomes than could be had otherwise (Majone 1998), even in the absence of widespread popular support. The complexity of the EU's political system makes outcome-oriented legitimacy necessary in order to resolve its democratic deficit problem (Scharpf 1999). But is output legitimacy on its own enough in a supranational (rather than national) context?

The importance of intra-European exchange rate stability, the reduced room for maneuver caused by increased capital mobility, and the disciplinary and credibility-enhancing effects of an independent central bank provided the economic rationale for European monetary union based on the delegation of monetary policy to a highly independent central bank. By the late 1980s and early 1990s, governments in developed and developing countries alike granted their central banks independence in hopes of boosting credibility and stabilizing price levels. Economists had found a negative relationship between central bank independence and inflation (Grilli, Masciandaro et al. 1991; Cukierman 1992), and some studies even indicated a relationship between central bank independence and stronger economic growth (De Long and Summers 1993), both of which the German experience seemingly corroborated. The widespread consensus in the economics and policymaking field on the importance of price stability and the efficacy of central bank in achieving it gained hold in Europe in the 1980s (McNamara 1998). The theoretical assumption is that central bankers have different incentives than politicians and therefore have fewer credibility problems, as the latter's short-term reelection objectives would lead to politically motivated monetary policy and higher inflation. Central bankers, on the other hand, can take a longer-term view of the economy and enjoy a better reputation for fighting against inflation (Kydland and Prescott 1977; Barro and Gordon 1983; Rogoff 1985; Barro 1986), leading to greater credibility and allowing for lower interest rates (as market actors do not anticipate inflationary policies), more investment and ultimately stronger economic growth.

The preference for institutions that would promote price stability was institutionalized in the ECB. Delia Boylan (2001) has argued that elites in new democracies designed institutions like independent central banks in order to cement their own preferences and make them more likely to survive changing political opinion in democracy. While this may be justifiable in democracies with potentially wide amplitudes of opinion and preferences, cementing these preferences in the form of relatively unaccountable international institutions like the ECB may not be in advanced democracies like those comprising the Eurozone. While the ECB was given the mandate of the pursuit of price stability, it has been able to define for itself what that means in practice (2 percent or lower in the medium-term), further exacerbating its critics discomfort with its high degree of independence.

Though it has succeeded in its objective of price stability, it has been routinely criticized for its indifference to its secondary objective, which is supporting the general economic policies in the Community (article 105.1). Whereas the ECB maintains that price stability is its primary objective and that other favorable economic outputs like competitiveness and growth require a foundation of price stability, price stability for its own sake is a weak argument for monetary integration. Moreover, some studies have questioned the link between central bank independence and price stability (Posen 1993; Lohmann 1996; Winkler 1996; Hall and Franzese 1998), as well as other economic objectives (Grilli, Masciandaro et al. 1991), with one study going so far as to write that it "has no measurable impact on real economic performance" (Alesina and Summers 1993).

Output legitimacy for monetary integration is thus critical due to the lack of input legitimacy. Despite its purported economic benefits, some authors nevertheless have questioned the legitimacy of relying solely on output legitimacy prior to the establishment of a community of shared values or the existence of a European *demos* (Verdun and Christiansen 2001). And though the ECB is modeled after the Bundesbank, the Eurozone lacks not only the societal consensus within Germany on the importance of price stability, it also lacks the system of accountability built into the Bundesbank's relationship with the German government and the input of social partners in policymaking (McNamara and Jones 1996; Verdun and Christiansen 2001). While the independent Bundesbank can therefore claim both input and output legitimacy, its successor cannot.

Despite technocratic justifications for monetary integration, it clearly rests on political foundations. Then-Bundesbank President Karl Otto Pöhl (1990: pp36-7) wrote "references to alleged huge savings in transaction costs for the countries of a single currency are not in the least convincing …[and] can be account for only in a broader political perspective, with the long-term objective of creating a political union." For Germany in particular, the economic consequences of giving up its D-mark for a new currency were ambiguous at best, as it had less to gain from monetary union than other countries (Ardy, Begg et al. 2005). Political reasons for monetary integration include greater political cooperation, in particular binding Germany to Europe after its sudden unification ((Garrett 1993; Sandholtz 1993; Baun 1996). Moreover, EMU's design under the Maastricht Treaty promised enough to appease the needs of the most important interests affected by integration (Verdun 1996), including the German government's desire for greater political cooperation, and non-German governments' wish for greater monetary sovereignty in the face of the D-mark dominated European Monetary System of fixed exchange rates that preceded EMU (Dyson and Featherstone 1999), national central banks' concerns for price stability, and commercial interests' desire for stable exchange rates and increased trading opportunities (Moravcsik 1998).

This disparate set of interests ultimately sought three (potentially interrelated) objectives from monetary union: increased political cooperation, greater influence at the European and international level, and greater economic growth. With monetary union well into its first decade, much remains to be achieved on all three fronts, though EMU has unfairly shouldered much of the blame for this. The next section outlines how and why EMU has thus far been unable to accomplish these objectives satisfactorily.

2. Mission Unaccomplished: Political Cooperation, Monetary Sovereignty and Economic Growth

First, the political cooperation that resulted from the Maastricht Treaty falls far short of the German government's desire for political union. The three-pillar structure introduced many new competences into the European Union yet left decision-making an intergovernmental affair. Even after the much-vaunted 1992 program, a truly single market has yet to emerge in Europe, as critical sectors like services remain under national control. The 2004 enlargement of the European Union did little to invigorate integration propensities. Indeed, the post-Maastricht Treaty grand project of the EU was its draft constitution, a politically ambitious effort to simultaneously involve EU citizens in the integration process and rationalize its previous treaties prior to subsequent enlargements. The failure to ratify the Constitution due to referenda results in France and the Netherlands was largely blamed on enlargement fatigue, the liberalization of European economic policy more generally, a poor understanding on the part of citizens what the Constitution actually comprised, and dissatisfaction with the management of the Eurozone on the part of the Netherlands. (Schild 2005) warns that the constitutional debate in France indicates a rise in the EU acting as a scapegoat for economic and political ills.

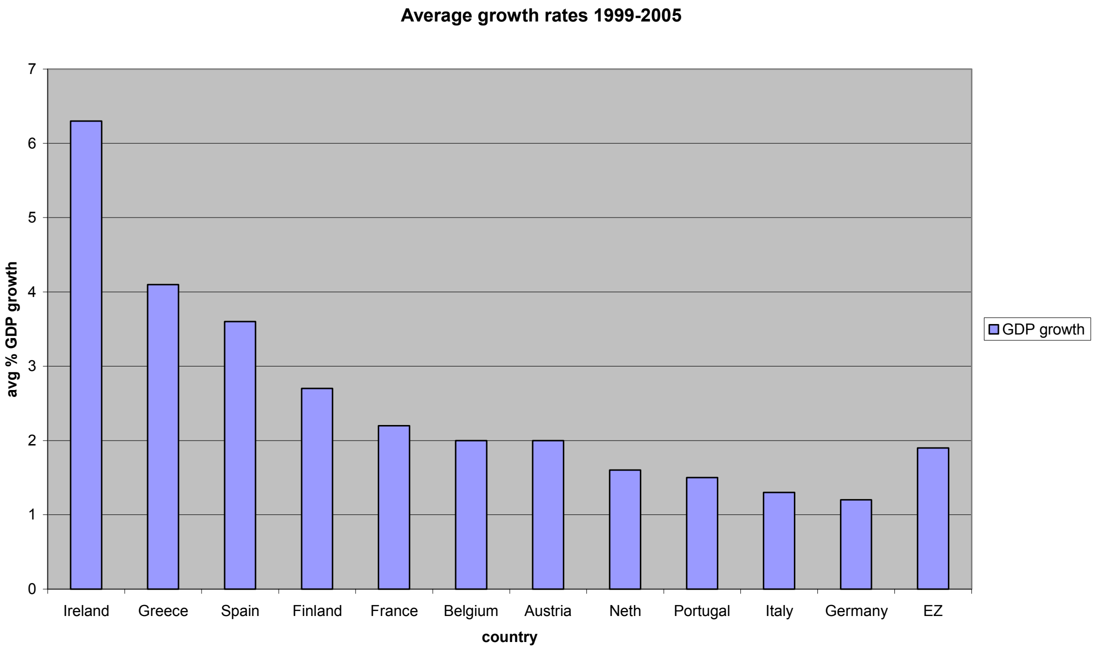
Despite the creation of the highly independent ECB, monetary union held the prospect of greater monetary sovereignty for most participants than its predecessor, a German-dominated EMS (insert cites). Interest rates would be taken with the Eurozone in mind rather than German economic conditions (though given the size of the German economy, it would still influence policy substantially). In addition, other countries gained important victories during the Maastricht Treaty negotiations to influence the composition and content of EMU, thereby introducing different political sensibilities into monetary policymaking and signaling a weaker consensus on price stability and the presence of more heterogeneous interests in monetary union than previously thought (Chang 2004).

However, despite the inclusion of less inflation-averse countries in EMU due to the possibility of a lenient interpretation of the Maastricht Treaty's convergence criteria, the ECB has dominated the Eurozone's monetary policy. The Eurogroup (a subset of ECOFIN comprised of Eurozone countries) did not emerge into the *gouvernement economique* that would serve as political balance against the technocratic ECB, as the French government originally had envisioned. Indeed, recent efforts by the Eurogroup to engage in a more intensive dialogue with the ECB were rebuffed by the ECB's president, who seemingly took delight and pride in his refusal to further consult with national representatives (*Financial Times* xxx). Thus it is difficult to argue that monetary integration substantially contributed to greater monetary sovereignty for the Eurogroup Member States.

The potential projection of power as a result of monetary union also included the international stage in addition to the aforementioned European one. Europe has long used monetary cooperation as a hedge against the dominance of the US dollar and its fluctuations. The creation of an alternative international currency threatened to dethrone the dollar and give Europe more influence in international monetary and financial affairs. According to Lorenzo Bini Smaghi, an ECB executive board member, the voting power of the EU in the IMF would approach 50 percent if their votes were coordinated, and even the votes of just the Eurozone countries would be double that of the US (FT, 5 June 2006).

Though the euro is undoubtedly a major international currency, it will be some time before it replaces the dollar as the international reserve currency (Cohen 2003; Galati and Tsatsaronis 2003). The euro does not offer enough advantages in terms of reduced transaction costs and greater stability in order for market actors to switch out of the dollar. The countries within the Eurozone would need to harmonize further their policies (Portes, Rey et al. 1998) and better coordinate their position in international forums like the International Monetary Fund and the G-8 (insert cites) before the euro could assume the leading role in international monetary affairs that the US has played during the postwar period.

Arguably the most important "deliverable" of monetary union was economic growth. In addition to the oft mentioned political rationale of political stability, one of the primary motivations for European integration in general is that membership offers opportunities to improve competitiveness and long-term growth prospects. The economic success of countries like Ireland, Spain and even the United Kingdom are partly attributable to membership in the European Union and the access to larger markets (goods and capital) and structural funds that membership offers. Monetary union based on the successful German model would presumably lead to greater competitiveness and economic growth. While some countries (like Ireland and Finland) have enjoyed an economic boom in the wake of monetary union, other countries remain mired in slow growth (notably France and Germany), with some having actually lost competitiveness (Italy—see Gros 2006). Indeed, the Economist (27 April 2006) remarked, "A solid currency, maybe, but a shame about the economic performance."



There are limits to how much interest rate policy (which is under the purview of the ECB) can affect economic growth. Former Single Market and Competition Commissioner Mario Monti remarked that EMU had produced disappointing results, attributing this failure to the still-incomplete Single Market and the intransigence of Member States to enact painful reforms (*Sole-24 Ore*, 24 November 2005, cited in Majone 2006 Notre Europe). National policies remain critical to a country's economic competitiveness and growth prospects. Though the Eurozone's growth rate appears sluggish, some economies have thrived, as Chart 1 indicates. Indeed, the most economically vibrant countries in the Eurozone have already implemented important reforms, particularly in labor markets. The larger Eurozone economies in particular have to make serious headway into politically painful economic reforms. Facing weak economic growth with no relief in sight, it is difficult for democratically elected governments to ask constituents to make further economic sacrifices, especially after numerous reforms had to be made in order to qualify for monetary union in the first place. The reward for monetary union was supposed to be economic growth. Instead, EMU policies may actually have a contractionary bias (Arestis and Sawyer 2003). Moreover, governments began falling under the confines of the strictures of the Stability and Growth Pact (SGP) just as European economic policy becomes more politicized post-EMU.

3. The Increasing Politicization of Monetary Policy in Europe

German Finance Minister Theo Waigel proposed the SGP in 1995 as an insurance to prevent Eurozone countries from budgetary laxity in the wake of monetary union. It essentially amounts to the continuation of the Maastricht Treaty's criterion on budget deficits being below 3 percent in perpetuity. The economic rationale for this was sharply criticized by numerous economists (Eichengreen 1994; Beetsma and Bovenberg 1998) who argued discretionary fiscal policy would be needed to compensate for a single interest rate policy. The political rationale for the policy lay in German domestic politics in the late 1990s. The German public's skepticism towards EMU made the ruling government vulnerable to criticism. In order to assuage public fears about sacrificing the mark for a weaker currency, the SGP was born (Heipertz and Verdun 2005).

Though fears of a weak and inflationary euro did not materialize, the politicization of monetary policy became an issue shortly after the start of EMU. Indeed, after the constraint of qualifying for monetary union was lifted in 1999, one saw the return of political business cycles in Europe (Buti and Noord 2004) and countries soon ran afoul of the SGP as government deficits breached the 3 percent limit. In 2003 the SGP was temporarily suspended in order to avoid the politically awkward penalization of the French and German governments for failing to control their deficits as per Commission recommendations. In order to accommodate the continued divergence in European economies and the political realities (European and domestic) against imposing sanctions, the SGP was revised in March 2005 and made more flexible (Donnelly 2005; Chang 2006).

On the one hand, the original SGP had caused some to note that EMU has an anti-growth bias due to the built-in fiscal constraints, which also prevents the Eurozone countries to exert their leadership in the international arena (Cohen 2003). However, the revised SGP will only work if governments use the flexibility cautiously and do not threaten the credibility of EU economic policymaking and cause markets to develop inflationary expectations. Nevertheless the overtly political process surrounding the SGP's application and reform contributed to more difficult relations between the ECB and Member States and also provided critics and skeptics with further evidence of the difficulties of economic coordination despite the single currency.

At the time of this writing, only four Eurozone countries still have excessive deficits: Germany, Greece, Italy and Portugal. In January 2007 the Council dropped the excessive deficits procedure against France, perhaps giving cause for optimism regarding the continued commitment of Member States to rein in deficits. The Commission optimistically views the reform as an opportunity for greater "political ownership" (Buti 2006). However others are less sanguine about the impact that peer pressure can have on fiscal discipline (Gros, Mayer et al. 2005). One year after the SGP's reform, a

Commission report noted the continued failure of Member States to consolidate their fiscal stance during good times and some even following pro-cyclical fiscal policies, which "runs against the spirit and the letter of the reform of the preventive part of the Pact" (Commission 2006, p16). Its most recent annual report on the Euro Area (Commission 2007: p8) observed that Member States were still not consolidating their finances; efforts were deemed lower than those achieved in 2005 despite the improved economic conditions. Indeed, rather than peer pressure within the Eurogroup leading to greater cooperation and policy convergence, the history of the SGP and its aftermath reflects a tendency towards competitive politics among the Member States as well as institutions.

The first division was between the Member States in the application of the SGP's strictures. Economists (Buti and Pench 2004) and political scientists (Chang 2006) have already noted the importance of country size in terms of Member State interests and their ability to influence the creation and implementation of rules to their benefit. The SGP was widely portrayed as a case of large countries versus small countries, with France and Germany leading the way towards reform and Austria and the Netherlands upholding the original SGP. Despite the strenuous protests of smaller countries both inside and outside the Eurogroup and warnings against weakening the credibility of monetary integration, a suitable compromise was found that largely conformed to the demands of the bigger countries.

The second division was between the Member States and other EU institutions. The Commission has steadfastly upheld the SGP rules across the board, implicating both small and large Member States. In November 2003 the Commission advised the Ecofin

Council to speed up the excessive deficits procedure against France and Germany. Instead the Council suspended the excessive deficits procedure so as to avoid politically embarrassing possibility of having to impose fines on two of its largest and most politically influential states. The Commission took ECOFIN to Court in protest (Case C-27/04). The subsequent Court ruling that ECOFIN must act on the Commission's recommendation (though not necessarily uphold it) was rendered politically inert, as by that time the Commission had revised its recommendation to begin proceedings against France and Germany. Instead, the Commission issued a communication that assessed the budget situation in France and Germany, noting that their budgetary plans should be on course to correct its deficits by 2005 (Com (2004) 813), hence there was no longer a need to open up excessive deficit procedures against them.

Though the conflict between the Member States and the Commission has at least temporarily abated, the one between the Member States and the ECB appears to be of a more lasting duration. The ECB was a harsh critic of certain Member States during the SGP ruckus, warning of the deleterious effects that deficits could have on inflation, thereby triggering a response from the ECB in the form of an interest rate rise. As early as July 1998, ECB President Wim Duisenberg cautioned that the failure to run balanced budgets would have negative implications for monetary policy (FT, 7/10/1988). After the suspension of the SGP in November 2003, the ECB expressed its concern that high budget deficit pose to the credibility of EMU, potentially creating the need to raise interest rates to preserve price stability due to the "crowding out of private credit demand" (ECB Monthly Bulletin, December 2003, p.55).

The ECB has found itself facing pressure from national governments in terms of its interest rate decisions and its relationship vis-à-vis the national governments. The French government had called for a *gouvernement economique* during the preparatory phase of monetary union in order to provide a political counterweight to the ECB. French republican political tradition lacked a precedent for the delegation of such power to a technocratic body, unlike Germany (Dyson and Featherstone 1999). The political compromise that resulted was what is now known as the Eurogroup, an informal subset of the ECOFIN council comprised of Eurozone that meets prior to ECOFIN in order to discuss matters of common interest. Despite the utility of this informal group in forming a consensus on monetary policy while retaining flexibility (Puetter 2004), the Eurogroup nonetheless falls far short of a *gouvernement economique*. One prominent observer underlined the lack of visibility of the Eurogroup when he claimed "Juncker (the Eurogroup chairman)? He has completely disappeared!" (*Le Monde,* 6 June 2006).

The idea of a political counterweight nonetheless persists. In 2005 French Prime Minister Dominique de Villepin revisited the idea of EU Finance Ministers conducting "a dialogue" with the ECB in order to reinvigorate "a new political Europe" (FT 11/29/2005). French Foreign Minister Philippe Douste-Blazy was blunter when he argued "Everyone can see that the euro today remains an unfinished project, for lack of a seriously co-ordinated economic policy between members of the Eurozone. Let us not leave economic and budget policy to the European Central Bank, let us not leave it just to the European Commission, to people who are not elected." (FT 8/31/2005). Most recently both French presidential candidates Segolène Royal and Nicholas Sarkozy criticized the ECB's policies and (FT 7 January 2007) its emphasis on price stability rather than growth and employment, thus underlining differences between government preferences and those of the central bank.

The Eurogroup's difficulty in exerting its influence was seen in the fall of 2005 when it unsuccessfully tried to dissuade the ECB from raising interest rates (FT 30 November 2005). In 2006 Eurogroup members pleaded with the ECB not to raise interest rates in light of the relatively high exchange rate and the still fragile uptick in growth rate (*Le Monde*, 6 July 2006). Eurogroup president Jean-Claude Juncker and Joaquin Almunia, EU monetary affairs commissioner, wrote to ECB President Jean-Claude Trichet to request more informal contacts (FT, 7 June 2006) "to foster a common understanding of the key policy challenges facing the euro area", a request to which the latter neglected to respond directly, dismissing the need for further Eurogroup consultation with "I'm Mr. Euro, there is no doubt. We issue the currency and, if I might add, there is my signature on the notes" (FT 9 June 2006). Juncker responded by noting, "I'm the first in line with responsibility for economic and fiscal issues in the Eurozone" (*FT Deutschland* 6/16/2006).

Though both parties later emphasized the spirit of cooperation that defines their relationship, a turf war has spilled over into the public sphere that does little to improve the credibility and reputation of either institution. Both are quick to highlight their respective responsibilities and to note their limitations. For example, Trichet rebuked the Member States, saying "A necessary increase in growth potential assumes the active implementation of structural reforms. Everyone believes that, it is a diagnostic on which we all agree, including the governments, the problem lies entirely with putting it into effect," with the "lack of flexibility" in European labour markets presenting a particularly vexing issue (*Agence France Press*, 31 March 2006).

The ECB's relationship with the Member States becomes even more complicated when one considers the latter's inability to speak with a single voice despite the Eurogroup and its appointment of a chairman with a longer term (2 years). In the summer of 2005 politicians from Italy, Germany, and France were demanding more cooperation from the ECB to stimulate growth, whereas the Austrian Finance Minister shifted the blame back to the Member States, "What is important is not that monetary policy and fiscal policy should be agreed more closely but that the financial policies of the individual countries themselves should be better co-ordinated," Mr Grasser said (FT, 18 July 2005). During the summer 2006 debate over the need for interest rate hikes, Spanish Finance Minister Pedro Solbes expressed his concern over the euro's exchange rate with the dollar *(Le Monde,* 7 June 2006) as did French Finance Minister Thierry Breton (FT, 11 June 2005), whereas Grasser claimed that ministers were "not very concerned" above it (FT, 9 June 2006).

Governments within the Eurogroup continue to make major economic policy decisions without the input of their Eurogroup counterparts. Germany's government under Angela Merkel decided to increase its VAT tax starting from 2007 without taking into account the reservations of countries like France and Belgium, which were concerned about the impact this would have on Eurozone growth (*Le Monde,* 6 June 2006). Moreover, national budgets are prepared and submitted to national parliaments via different procedures at different times of the year. ECB Executive Board Member Lorenzo Bini-Smaghi (2005) has offered ambitious policy reforms to rationalize national budgetary processes for Eurozone countries, as the continuation of national practices and traditions no longer makes sense in an integrated Eurozone.

Given the divergence in economic performance and strategy among the Member States, the difficulty of sharing a single interest rate becomes clear. Monetary union led to a convergence in bond spreads in the Eurozone, weakening market discipline of more fiscally profligate countries. In order to restore such discipline without negatively affecting more economically sound countries (which an interest rate hike would do), the ECB publicly warned banks that they would no longer accept as collateral the sovereign debt of countries with a rating of less than A- from one of the major ratings agencies (FT 8 November 2005). According to Erik Nielsen, chief European economist at Goldman Sachs, "While this policy may have little direct impact in the short term because even the lowest rated member remains three notches above the cut-off, it is a huge development and has potentially substantial and positive implications longer term...as it will induce markets to discriminate more between government bonds based on their rating and the debt situation of Euroland countries." (FT 10 November 2005).

This need not immediately have affected any of the Eurozone countries, as all were within range. Nevertheless, the impact was felt almost immediately by some of the weaker economies of the Eurozone. For example, after the ECB's announcement, investors demanded from Portugal (rated 3-4 notches above the ECB's minimum level at the time) a yield spread of 11 basis points above comparable AAA-rated German government on its new five-year bond issue, whereas prior to the announcement, it had offered 10bp. Some investors nonetheless pulled their orders (FT, 9 November 2005).

How can we explain this rift between EMU's major macroeconomic institutions? I offer three interrelated explanations: the differing incentives of the two institutions, the open-ended institutional design of monetary union, and the struggle for legitimacy that both face. On the one hand, the ECB has been charged with guarding price stability in the Eurozone. On the other hand, Member States retain the ability to set fiscal policy within the constraints of the SGP, which have proven to be less than constraining. Some economists have argued for the necessity of some leeway for the Member States; in light of the loss of interest rates as a policy instrument, flexible fiscal policy becomes even more important to governments as a tool of economic adjustment (Eichengreen and Wyplosz xx). To the extent that this creates inflationary pressure, the ECB potentially becomes both "policeman and judge" in battling potential threats to price stability through the threat of interest rate hikes, though thus far it remains just a threat that has not yet been used (Howarth and Loedel 2004). Nevertheless their relationship by its nature becomes adversarial.

The open-ended nature of macroeconomic coordination in the EU can be blamed on the continued divergence of preferences among Member States (Ardy, Begg et al. 2005). This necessitates the use of the principle of subsidiarity and the need for flexible policy instruments and interpretations in order to hold together a still-disparate group of economies whose political loyalties lie primarily at the national rather than the European level. De Grauwe (FT 2005) argues that the problem lies in the fact that the institutions managing the Eurozone economy (the ECB and the Commission) do not bear political responsibility for the outcomes. The national governments, which can be voted out of office by unhappy constituents, use the fiscal policy instruments still at their disposal in order boost employment, the natural response given their accountability structure. Thus,

> The legitimization of the Eurozone governance structure by the new classical theory can only mask the weakness of this governance. Its weakness has everything to do with the fact that the power to manage the Eurozone economies has been given to European institutions that bear no political responsibility for their actions, while the national governments which have lost their macroeconomic instruments, are made accountable before their national electorates for the failures of macroeconomic management at the European level. Despite its intellectual backing, this poor governance will turn out to be unsustainable. (de Grauwe 2005)

This leads me to my second point, the open-ended design of economic governance in EMU. While the ECB has a legal obligation to pursue price stability, the Member States are accountable to national electorates. Though they potentially can be fined if they fail to respect their obligations to the EU, this fate is less threatening (and increasingly less likely) than being thrown out of office. Indeed, the ability of voters to elect a new government and thereby achieve a change in policy lies at the heart of a democracy, despite international obligations that a previous government may have made (Collignon 2004). Governments also recognize their obligation to (and interest in) introduce policies that voters want even if they are different than those employed by the previous government. The reluctance of governments to further delegate policymaking power to supranational institutions and lock in a specific preference has led to a preference for soft law, a situation that has become increasingly apparent over time. (Hodson and Maher 2004) note that while the SGP was created with an emphasis on hard law, its implementation favors soft law because of the limits of formal economic coordination, in which "obligations are largely unenforceable, difficult to measure, and there is little or no delegation of interpretation and implementation from ECOFIN to either the European Court or the Commission" (p801). In addition, the Lisbon Strategy featured the soft-law based open method of coordination for policy rather than the traditional community method so as to allow Member States to retain their ability to run independent policies (despite the possibility of being persuaded to run policies more in line with those of their EU partners).

The open-ended nature of EMU governance exacerbates the delicate balancing act of the Eurozone for achieving market credibility along with democratic legitimacy, as the ECB and the Member States have been competing with one another in order to increase their own claims towards legitimacy. The ECB lacks input legitimacy and its output legitimacy is rather shaky: though it has delivered on its mandate of maintaining stable prices and interest rates are low throughout the Eurozone, growth and employment levels do not match expectations. It must therefore retain the legitimacy it derives as a technocratic body that cannot be influenced by short-term political demands in order to boost its credibility with its ultimate judge, financial markets. If financial markets were to question the stability of Eurozone macroeconomic policy and we saw a return to the currency speculation (this time against the euro) of previous decades, this would be a devastating blow to this fledgling institution. Therefore the ECB remains extremely vigilant in regards to its policymaking territory, which it must defend against possible encroachments from the Member States. Given its lack of public support and its relatively short history, its legitimacy and therefore its independence is still under threat. This fight for its continued survival has caused the ECB to react sharply to Member State attempts at engaging in a dialogue.

Democratic governments cannot reasonably be expected to act counter to the expressed wishes of their constituencies, resulting in tension within Ecofin and the Eurogroup and at times bringing it into conflict with the ECB. Given the ECB's own questionable democratic credentials, the most logical disciplinary force for governments is not the Commission, the ECB or even one another but the actor that had precipitated much of the convergence prior to EMU: financial markets.

4. Enhancing EMU's Credibility: Markets and Institutions

Financial markets hold the most effective and credible punishment for non-adjustment. Indeed, monetary integration's design was specifically tailored to enhance the Eurozone's credibility with markets. When exchange rate cooperation once again came upon the European agenda, the primary objective was exchange rate stability in light of the dollar's volatility during the 1970s (Ludlow 1982). Another benefit from EMS membership emerged, that of increased credibility as government's commitment to the pursuit of price stability became more credible (Giavazzi and Pagano 1988). EMS participation raised the costs of devaluation, which were decided jointly by member states. The steady decline in long-term interest rates between Germany and other member states confirm the market's lowered expectations of devaluation and inflationary policies in the run-up to monetary union.

However, post-EMU the market has seemingly failed to react to both the deteriorating fiscal conditions in the Eurozone's largest economies and the subsequent political battles that emerged over it, as long-term interest rates remained stable. On the other hand, the market's non-reaction to fiscal developments in the Eurozone could indicate that the markets, not viewing the Stability and Growth Pact as a credible institution anyway, had already assessed the long-term conditions regarding savings and investment, which have not changed substantially over the last few years despite the SGP's difficulties. The battle between Ecofin and the Commission and the reform of the SGP would thus not be considered major events. Moreover, the chance of any of the Eurozone governments defaulting on their debt is negligible (Fitoussi 2005; Wyplosz 2005).

However, there is still cause for concern, as Eurozone governments would essentially share the costs of fiscally profligate members through higher interest rates (Dehesa 2005). Thus Financial Times analysts such as Wolfgang Munchau (FT 14 March 2005) and Joachim Fels (FT 1 April 2005) argued that ECB should encourage market discipline of member states by discriminating amongst governments in terms of their ratings. Indeed, some researchers have found significant yield differentials between government bonds from Eurozone countries (Codogno, Favero et al. 2003), implying continued market discipline on fiscal policies (Bernoth, von Hagen et al. 2004).

Nevertheless, other researchers were less sanguine about the market's ability to discipline governments due to the relatively small reaction of markets to fiscal imbalances (Balassone, Franco et al. 2004). Despite the increased fiscal rigor that countries demonstrated in the run-up to monetary union, since 1999 this has given way to fatigue (Fatas 2003), even the return of political business cycles (Buti and Noord 2004). According to (Feldstein 2005), "there is no market feedback to discipline large budget deficits" (p2).

While the market could effectively discipline Member States, its complacency towards the current situation has done nothing to enhance the legitimacy of EMU. One mechanism that has been attempted is the dialogue between the ECB and the European Parliament, which would supposedly make the former more accountable and transparent and ultimately more legitimate. However, the paucity of publicity in major media outlets as to the outcome of these hearings makes it difficult to argue that this in fact enhances EMU's legitimacy in more than a theoretical fashion. In addition, the EP's lack of sanctioning mechanism should it disagree with the ECB's actions further underlines the weakness of this mechanism (Chang 2002). Thus resolving the credibility and legitimacy of EMU through the ECB is unlikely in the short-run, though in the long-run.

Another suggestion has been increasing the power of the Commission. As a neutral actor, it would be in a stronger position to treat the Member States equally and mitigate charges regarding the political bias inherent in EMU (Wyplosz 2005; Hughes Hallett, Lewis and von Hagen 2003). However, Member States are unlikely to relinquish their prerogative over the application of sanctions.

The most radical idea proposed has been that of political union, which would provide the EU with both the coercive power and ability to redistribute resources needed to stabilize EMU (de Grauwe 2006). While the EU has been steadily expanding its authority into new issue areas, the idea of political union is still highly speculative and theoretical. Nevertheless, it does highlight some of the major problems associated with monetary union. First, while the weaknesses of monetary union have been highlighted (often by EU actors themselves), its strengths rarely receive much attention. The lack of coercive power of the EU to prevent exit means that on some level the option remains;

EMU is not necessarily viewed as irrevocable. For this reason more needs to be done to publicize the benefits that have been achieved as a result of monetary union. Second, the redistributive consequences of monetary integration also need to be recognized. It was acknowledged early on that some countries (Greece, Portugal, Spain and Ireland) would have a difficult time achieving the Maastricht Treaty convergence criteria, thus contributing to the construction of cohesion funds. While the EU could not undertake redistribution on the same scale as a national government could, it would be useful to introduce measures to monetary integration that could be seen as helping Member States rather than solely waiting to punish and reprimand them.

5. Conclusion

The design and implementation of monetary integration exhibits some of the worst elements of the democratic deficit that plagues the EU more generally. First, its legitimacy rests on an ex-post legitimacy based on outcome, but the ideas behind the policies and institutions do not enjoy the necessary support at the national level. Second, the institutional configuration of EMU has created inconsistent monetary and fiscal policies with an unclear structure of accountability, contributing to suboptimal economic outcomes and public dissatisfaction with EMU.

The ECB and national governments must conduct monetary policy in a more efficacious manner that gives both parties incentives to cooperate with one another rather than exploit disagreements for political gain. In particular the nature of European integration makes it difficult to separate sectors like monetary integration from perceptions of European integration in general. Therefore dissatisfaction with monetary integration and government unwillingness to abide by restrictions it places on states correspond to the generally pessimistic environment that Europe finds itself in. Political will must be found domestically (making balanced budgets a priority in conjunction with and not counter to the general direction of the government's policy program), at the EU level (the reinvigoration of integration more generally, most likely via a new grand project), transnationally (market pressure on bond ratings spurring policy changes) or in some combination.

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