How were such great hopes dashed?

Here was a new central bank and a new monetary union which started up at the end of the 1990s. Yes, there were the cynics right at the start, including Milton Friedman who warned that EMU would not survive the first serious recession.

But the euro-enthusiasts – and they were now in charge of Europe’s monetary destiny – boasted that a new financial economic and political future had dawned.

The boast proved to be empty of content. One decade later that monetary union was submerged in the aftermath of a credit bubble which seemed to be as bleak – and on some accounts bleaker – than in the US! Political integration had made no progress at all (despite the claim of Jacques Delors that monetary union would be the catalyst to political union – see Brown, 2004) and on some accounts had moved backwards. Financial integration had moved into reverse gear.

An incipient flight of capital out of the government bond markets in a range of financially weak member countries had brought the scenario of EMU break-up or shrinkage within the mainstream of investor vision around the globe. Embarrassed euro-officials who had been praising their own record at the official tenth anniversary events had to issue statements of denial, mainly to the pompous effect that anyone who saw the danger of EMU exit must be idiotic or deluded!

In this chapter the task is to look at the history of EMU in the years up to the peak of the bubble, say early 2007, and pick out the salient factors of ensuing malaise. In effect this chapter assembles the evidence from this period towards justifying the indictments of Chapter 1.
Historical observations of Otmar Issing

Let us start with the evidence provided by Professor Otmar Issing, founder member of the ECB Board and its first Head of Economics and Research.

Much of this testimony can be found in his book *The Birth of the Euro* (2008). There he states (written in late 2007?):

Nine years on (from the run-up to the launch of EMU), the ECB can lay claim – virtually undisputed – to the success of its monetary policy. Those observers that remain sceptics at heart might at most add the qualification ‘so far’. Over this period, the average annual increase in the HICP has been 2.06 per cent. […] Even the D-mark performed considerably less well over the period from 1950 to 1998, with a rate of 2.8%.

Well here is the statement of a single-minded general who achieved his target, never mind the cost! In this case the bill was soon to be presented in the form of an almighty credit bubble and burst. The historical comparison (with the D-mark) on close examination includes an element of fiction alongside fact (see p. 131).

Let us start with the first big policy decision in what Professor Issing claims was a decade of monetary policy success.

First big monetary policy decision was a big mistake (1998–9)

With inflation in the euro-area as a whole running at just 1% p.a. at the start of monetary union, the ECB decided in favour of monetary easing. In early December 1998 while the national central banks were still legally in existence as sovereign policymakers, the ECB (which had grown out of the European Monetary Institute, opening its doors on 1 July 1998) arranged for an across-the-board cut of official rates by all participating countries. Accordingly the official repo rate set for the start of EMU was at 3% p.a.

In a second policy move in April 1999 the Governing Council decided to reduce again all policy rates. The main refinancing rate and the deposit rate were both reduced by 50 basis points, to 2.5% and 1.5%, respectively.

Albeit with the benefit of hindsight, this sequence of monetary easing through late 1998 and early 1999 was deeply unsettling for the new