THE FIRST STEPS OF THE EURO, AND ITS POLITICAL IMPLICATIONS

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Contents

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In the autumn of 1997, Martin Feldstein, Professor of Economics at Harvard and President of the National Bureau of Economic Research, published a controversial article in *Foreign Affairs* maintaining that, should the euro become a reality, it would radically change the political and economic map of Europe and could unleash conflicts either within the continent or, alternatively, between Europe and the United States.[1] Feldstein argued that the euro could fail owing to the impossibility of reconciling cycles and macroeconomic cultures as disparate as those of the French and the Germans. It could also fail if, as had been predicted, those problems were to dictate the political unification of Europe, and this unified Europe subsequently sought to take on the role of a global superpower. If the economic, monetary and political unification of Europe were consummated, concluded Feldstein, "the world will be a very different and not necessarily safer place."[2]

The obvious question to ask is what the grounds are for his reasoning, as it is perhaps illustrative of the difficulty that part of the American élites have in comprehending the complexity of the European construction process. An incomprehension, it must be said, that it shares with a no less numerous part of the European élite itself. As well as examining these cultural misunderstandings, our aim is to use Feldstein's article as a reference point from which to offer a brief summary of the two years since his article was published and, particularly, of the year that has gone by since the launch of the euro. We try to analyse the impact of the début of the euro on the European construction process, and the direction in which the European Union (EU) appears to be going at the turn of the century and the millenium.

1. The soft landing of the euro: some unanswered questions

During the first year of the euro's existence, the economies of the participating countries have maintained their fundamental equilibrium, they have controlled inflation and, up to a point (if we overlook the laxity prevailing in the Italian case), they have followed policies that are in line with the principles of the Stability Pact, particularly as regards control of the public deficit. But, primarily, their success has also been dependent on a time of economic growth with low inflation and interest rates, leading almost automatically to reductions in the burden of public debt. At the same time, governments have transmitted a sense of purpose and stability to the markets sufficient for the latter not to penalize them with high rates of interest on that public debt. So far, at least, the experience can be considered a success.

This has reinforced the credibility of the new financial institutions such as the European Central Bank (ECB). Although, at times, the Commission and the European Parliament have taken the center of the stage in the European construction process, the Council of Ministers has been the forum where the fundamental decisions have been taken to vitalize the ongoing process, demonstrating that it enjoys a wide margin and sufficient power to coordinate the policies of the member states efficiently. Nevertheless, this should not prevent recognition of the decisive contributions made by certain members of the Commission at crucial moments, nor the general support of the Parliament for the course of events.

In addition, the début of the euro has demonstrated the relative convergence between the cultures of economic policy prevailing in Northern and Southern European countries, and between the political parties considered to be center-left, like the social democrats, and center-right, like the christian democrats, conservatives and *populares*. All of them claim to be searching for some kind of combination or accomodation between the requirements of a globalized market economy that presses for public policies to fight inflation and impose fiscal restraint, (relative) deregulation and privatization (etc.) on the one hand; and the desire to retain a relatively generous social welfare system with a broad public component, on the other. In this respect at least, it appears that the majority of European parties coincide (and not only the mainstream parties, as the German Greens have demonstrated now they have had a taste of federal government). However, they also believe that the necessity of maintaining their own party political identities obliges them to conceal their similarity occasionally, and even to deny it in public. The firmness and clarity with which the Labor government of Tony Blair has expressed its political

[1] This article has benefited substantially from the comments of Juan Carlos Rodríguez. Its authors wish to acknowledge and thank him for this contribution.

[2] See Feldstein (1997). For a more optimistic, alternative vision in the long term, see Bergsten (1997). See also Dornbusch (1996).

convictions to this effect have been highly unusual. It is even possible that these virtues (of firmness and clarity) may be communicated to some extent to similar parties in other countries.

However, in spite of the convergence of opinions, no significant progress has been made to increase employment or even to formulate policies to encourage it. It is clear that, although training policies are very commendable, they and other similar measures cannot substitute a basic supply policy aimed at increasing the flexibility of the labor markets. It is a process that continues to evolve very slowly, although there are some hopeful signs (that seem a little insignificant to the sceptical observer, given that they are identical to those described scrupulously by European experts, academics and politicians over the last twenty years). In this sphere, the introduction of the euro has been practically irrelevant; although it may have had the (indirect) effect of distracting attention from the question of employment, thereby reinforcing the status quo in those countries most reluctant to undertake decisive reforms of their labor markets. Neither have any very significant steps been taken to correct what are referred to as the (structural or cyclical) “"asymmetries” of the European economy.

The initial fears

The third phase of the economic and monetary union (EMU) contemplated in the Treaty of Maastricht (that took effect on 1 November, 1993), began on 1 January, 1999, when the rates of exchange between the eleven countries participating (all the EU members with the exception of Denmark, the United Kingdom, Sweden and Greece) were irreversibly fixed preliminary to the launch of the euro. In addition to the introduction of the euro, the third phase of the EMU is characterized by the ECB assuming responsibility for the monetary policy of the euro zone. Accordingly, the euro interest and exchange rates have become the responsibility of the banking authorities, presided over by Wim Duisenberg, with their headquarters in Frankfurt.

A new European institution has been created whose two fundamental characteristics are its responsibility for monetary stability (or control of inflation), which is its main aim, and a high degree of independence from the political powers, at least on paper. At a stroke, the participating member states have lost control over two crucial elements of economic policy: the possiblity of adjusting the exchange rate upwards or downwards, and the power to modify interest rates (as well as, obviously, recourse to the issuing of money in order to finance public debt).

The independence of the the ECB is, logically, the essential point, but whatever the letter of its provisions, they inevitably have to be taken in context. The way in which the first President of the Bank, the Dutchman Duisenberg, was appointed, and the so-called subsitution pact to replace him before the end of his term are symptomatic of a situation that is more complex than what a literal interpretation of the game rules would lead us to expect. Furthermore, it is obvious that the zeal for autonomy or independence on the part of any governmental or inter-governmental agenda must be tempered by reality, which is manifested through multiple voices. It could be argued, and may even be demonstrated, for example, that it is absurd to insist on high rates of interest when it is clear that, on occasion, a lack of liquidity can strangle any possibilities of growth.

In order to participate in the euro, member states not only had to fulfil a series of convergence criteria established by the Maastricht Treaty with respect to inflation, public deficit, interest rates and public debt; they were also obliged to follow the directives established in the Stability Pact of 1995 concerning austerity in public spending, and to comply with the corresponding sanctions if they failed to meet their commitments. If the third phase of the economic and monetary union goes ahead according to plan, it will culminate on 1 July, 2002 with the withdrawal from circulation of all the national currencies and their complete substitution by the euro.

For some, like Feldstein and Dornbusch, the third phase has few possibilities of being introduced as planned and, furthermore, they believe that if it were the results could be disastrous. According to them, the EMU will have exactly the opposite effect to the one intended by its founders: instead of uniting Europeans and guaranteeing peace, it will divide them and set them against one another. This argument, widespread among economists on both sides of the Atlantic, is based on their conviction that the different conceptions held by the EU member states about what the objectives and instruments of monetary policy actually are, are not merely circumstantial but based on deeply-rooted traditions. These traditions reflect profoundly different economies, societies and cultures, and they will make the euro ungovernable.

In general terms, the argument goes, we are talking about the existence of two different monetary traditions and cultures. On the one hand, we would have the monetary culture headed by the Germans and extended throughout Central European and Scandinavian countries that, for historical reasons, tends to give priority to holding down inflation at all costs (having attributed the failure of the Weimar Republic and the ascent of Nazism to the hyperinflation that occurred after the crisis of 1929). At the other extreme, we would have the Latin monetary culture, supposedly headed by the French, for which inflation is not only tolerable as a means for combating unemployment in the short term, but even useful for ensuring continuity in power. According to this argument, the ECB, the theoretical bastion in the fight against inflation, would be besieged and eventually defeated in practice by the populist pressure brought to bear by the "latin" member states and channelled through the Ecofin (Council of Ministers of the Economy and Finance). This would lead to the launching of active employment policies and new taxes at a European level as well as an increase in the financial transfers between regions. Whichever side emerged victorious, the ungovernability of the euro would become a certainty, and mistrust and conflicts arising from the differences in the economic cycles between countries, would be guaranteed.

How would these conflicts be expressed and what would their consequences be? The impossibility of adjusting monetary policy to the specific necessities of each country, continues Feldstein (ibid., pp.66-67) would result in the harmonization of taxes and their centralization in Brussels. Why? Because without the freedom to devalue, modify interest rates or increase the public deficit, the countries with the highest levels of unemployment would conclude that the easiest way of fighting unemployment would be to demand that Brussels increase the financial transfers between countries (although the most effective way would be to undertake their own policies of labor market reform). In order to avoid conflicts and claims of discrimination, Feldstein argues that taxes would have to be harmonized and tax collection and spending centralized in Brussels. Paradoxically, he concludes, the effect would be the opposite to the one intended: centralization would make it impossible for individual countries to fight unemployment in the way most appropriate for them at a given time, and it would even aggravate the basic parameters of the problem (by creating excessive regulations and rigidities, and high taxes and social benefits).

In short, the attempt to impose a single monetary policy would, domestically, be the cause of lower competitivity, high taxes, high structural unemployment and high inflation, while externally, it would lead to a large increase in tariffs that would endanger the world trade system and lead inevitably to conflicts with the United States. In these circumstances, it is to be expected that some member states, particularly the smaller ones, would wish to withdraw from the EU, but as the EU has no legal withdrawal mechanisms, conflicts would be inevitable. (Feldstein actually cites the War of Secession in the United States, justified by a reading of the Constitution that was wholly intolerant of secession; ibid, p.72).

In fact, Feldstein's views reflected a broader school of thought that believed it neither desirable nor probable that the euro would ever be introduced within the specified time period. In early 1997, not even the Germans or the French were in a condition to fulfill the admission criteria of the third phase, and even in March, 1998, only a few months before the final screening to determine which countries were eligible, some hundred and fifty German professors begged Helmut Kohl to delay unification.[3] Others believed that, even if the euro were introduced, its reach would be limited to so few countries within the EU that its international impact would be practically nonexistent.

Nevertheless, the fact is that in January, 1999, 11 EU countries did sign up for the third phase of the EMU, and that the United Kingdom and even Greece are considering doing so before the year 2002. The 11 member EMU is a success, not only because of the size of the economy and the market that have come together under the umbrella of the euro, but in political terms. A healing of the breach between the Northern and Southern countries of the European Union is an event of historic importance that few were able to foresee, and it opens up new horizons. Moreover, the introduction of the euro, described by many reputable economists as a reckless leap into the unknown, and carried out in conditions of the almost complete integration of the world financial markets,

[3] *El País Digital*, 10 February, 1998, nº 648.

has been well received by the world economic markets and operators.

Relative success

In spite of the somewhat turbulent inauguration of the ECB, dominated by the dispute between France and Germany over its presidency, the strength and credibility of the European monetary institutions have apparently been acknowledged. Combined with the weight of the European economy, the good macroeconomic results achieved by the policies of austerity and discipline imposed during 1997 and 1998 have provided and indirect support to those institutions; even though they are subject, as is logical, to the scrutiny of capital markets that tend to lack the deference with which many public officials and media agents treat the decisions of governments, (particularly those to which they are politically sympathetic). After the launch of the euro, and taking into account the general tenor of the fiscal policies of most countries, the Stability Pact has generally appeared to have credibility, even though it was only loosely applied by member states on the first occasion that persistent difficulties have arisen (the Italian deficit).

Therefore, with some reservations, we can affirm that the euro has been a success. The most optimistic observers believe that it has inherited, as it was meant to inherit, the prestige of the German mark, and that it is already on its way to becoming a reference currency alongside the dollar in the international markets. On their part, European economic agents have given evidence of their faith not only in the viability of the euro but also in the opportunities for growth that it offers, unleashing the process of giant mergers creating business conglomerates that the financial markets have been demanding for years. It is probable that this, in turn, has encouraged some governments in the euro zone to speed up their programs of privatization and market liberalization, measures that are useful for maintaining expansion of demand and creating employment without the need to embark on extensive tax policies. Conversely, however, it reduces their motivation to reduce spending, lower taxes or introduce a more decisive supply policy.

As a result, the view that was so widespread among many economic and political circles on both sides of the Atlantic in 1996 and 1997, predicting that the introduction of the euro would be the *coup de grâce* for a Europe paralyzed by an unworkable and self-destructive social model, has been provisionally suspended. The prestigious economist of the Massachusetts Institute of Technology, Rudi Dornbusch (ibid., p.113) affirmed in the autumn of 1996: "The struggle to achieve monetary union under the Maastricht formula may be remembered as one of the more useless battles in European history. The costs of getting there are large, the economic benefits minimal, and the prospects for disappointment major.If there was ever a bad idea. EMU is it". In our opinion, that judgement seems premature.

The debate on the strength of the euro continues, and it has been fanned by the apparent imminence of its parity with the dollar. However, most observers coincide in pointing out that, since 1997 at least, the debate has been misdirected: the strength or weakness of the euro should be measured in terms of the growth rates of the European economy and inflation, and not as a function of the exchange rate with the dollar (to this end, we remind the reader where a strong but over-valued peseta recently left Spain). The flucutations of the dollar and the euro are not a worrying sign: in January, 1999, the predictions of growth for Europe and the United States drawn up by the OECD were 2% and 1.6% respectively. Six months later, the United States was growing at a rate of 3.6% and Europe at 1.9%: and, in fact, Germany and Italy, which represent 45% of the euro zone economy, were growing even more slowly. All this could be considered as merely cyclical. It could even be thought that the substantial reduction of that 20% differential between the dollar and the euro when it was launched in January is beneficial for the competitivity of European exports in the short term, even if it has a negative effect on the level of imports. However, the problem is not only cyclical; and moreover, we know that a disparity between currencies (apart from simply betraying a mistaken economic policy) can reflect, above all, a disparity between the economic dynamism on either side of the Atlantic. What is clear is that the disparity in this case translates into the enormous difference in the capacity to create employment between the United States and Europe.

Is there convergence between the cultures of economic policy?

The principal argument in recent years over the irrelevance or undesirability of the euro has been based on two assumptions: the inability of Europeans to make employment creation and economic growth compatible with low rates of inflation and the rationalization of public accounts, and their inability to even control inflation and public expenditure at all. Until recently, European élites had decided to virtually ignore the first question and concentrate almost obsessively on the second. This allowed Northern Europeans to express their doubts about the governing skills of their European counterparts in the South. Thus, in the years prior to the introduction of the euro, the Germans and the Dutch, for example, often protested about the relaxed "latin" attitude to controlling inflation, associating it with lower levels of economic and social development and a generally lower level of collective competence (what is contemptuously called "Club Med"). As a result, many of them have not concealed their preferences for a two-speed Europe, with a hard core capable of the necessary economic and monetary discipline that would serve as the basis for true integration. In turn, many members of the latin countries, including the French, have resented this scepticism, and they have not hesitated to attack what they consider to be an exhibition of arrogance, and to refuse any kind of exclusion mechanism.

However, at the crucial moment, countries Nordic and Latin, Protestant and Catholic, governed by the center-right and the center-left, buried their differences and committed themselves to the economic convergence criteria and the Stability Pact. Within each of these great European cultural families, a process of persuasion and contagion had taken place, evidence of which is the warning of José María Aznar (Spain - center-right) to Romano Prodi (Italy - center left) in the autumn of 1996. He declared that Spain was determined to apply for entry into the euro in the first round and not (according to the supposedly latin model that constantly changes the game rules) to join forces with Italy in negotiating a last-minute "political" entry together (perhaps by stopping the clock?) that would permit some countries to interpret the criteria more loosely than others.[4]

Feldstein (ibid., pp.53-64) goes on to draw our attention to a sequence of events assumed to have occurred between 1992 and 1997 that would confirm the assault on, and eventual defeat of ECB independence. In our opinion, he offers a somewhat exaggerated interpretation of events that should really be considered *non*-events. We could even say that he interprets some events in the wrong way, like the European Council decision on the Stability Pact in Dublin in 1996, that was to reinforce the convergence process; or the chapter on employment introduced into the Treaty of Amsterdam, that in practice represented the success of Tony Blair and coordination in the face of Lionel Jospin and harmonization; or the innocuous resolution of the European Parliament requesting the ECB to keep it informed at regular intervals.

What has actually happened? As regards inflation, Feldstein (ibid., p.65) warned that the member states would be disciplined in their race for the euro, but once their admission had been guaranteed and the disciplinary effect of the Bundesbank had disappeared, the participating countries would use their votes on the ECB Council to relax monetary policy in favor of higher levels of employment. Although this would temporarily create jobs, Feldstein argued that, in the longer term, unemployment levels would remain the same while inflation rates would be higher. This would lead to new rounds of monetary relaxation that would inevitably alienate the countries with least inflation.

The most obvious criticism that can be made of this argument is undoubtedly its inaccuracy, since it involves the radical negation of the *raison d'être* of the ECB. It assumes a complete violation of the two essential elements of its identity: the independence of its members in relation to national governments, and the objective of holding down inflation. To claim that the ECB would become an inflationist agent at the hands of some of its members submissive to their respective governments (!) takes daring but, for precisely that reason, it also requires convincing evidence.

This evidence has not been forthcoming. The introduction of the euro has been accompanied by macroeconomic stability resulting in good behavior on the part of the economy. While inflation has been held down, there has been economic growth, though only marginally in some countries. Under these circumstances, the ECB has become "politically invisible": it has managed interest rates with caution, it has declined to become a leading player and it has not risen to the "provocations" offered it by the political powers (if the zigzags of Oscar

[4] See Rodrigo (1998).

Lafontaine can be considered as such).[5] Far from fulfilling Feldstein's predictions of the inevitability of an inflationary raid by the Ecofin, events have been marked not only by generalized acceptance of the virtues of macroeconomic rigor and monetary stability but also by enjoyment of the benefits of low inflation and low interest rates (especially as regards the costs of financing public debt), together with an increase in tax income as a result of a flourishing economy (in France and all the other countries).

Given his arguments, it must come as a surprise to Feldstein that a concurrent majority of social democratic governments in the European Union (and principally in the three most important countries: the United Kingdom, Germany and France), as well as a (relative) social democratic majority in the European Parliament (that they lost in the recent European elections) has allowed such a wondeful opportunity to bind the ECB to an inflationist policy to have passed them by. However, it is probable that the euro has made an enormous (possibly unexpected though not unhoped for) contribution to bringing about a significant change in the economic and monetary policy preferences of European social democrats (which, for the optimists, may be definitive and irreversible).

In effect, macroeconomic stability and rigor have not only been widely accepted by the different political tendencies, they have also come to be adopted by the social democrats as either tools for the achievement of their traditional objectives, or measures that are least compatible with them, when once these objectives have been redefined as high levels of employment and social welfare through careful management of public spending and social policies.

From this viewpoint, it could be thought that the public positions upheld by Oskar Lafontaine during his brief passage through the German government were more rhetorical than real. This is a conclusion which could be eventually supported by a benign reading of the letter signed jointly by the French Minister of Finance, Dominique Strauss-Kahn, and Lafontaine himself in January, 1999, as well as of his actual disputes with the Central Bank, and his vaguely outlined declarations in favor of supply policies[6]. It could also be thought, from a more detached perspective, that they are evidence of a minister naturally inclined towards state intervention and regulation but forced by circumstance to curb his impulses in the hope of a better occasion in which to give them free rein. At all events, that occasion will no longer be forthcoming, as Oskar Lafontaine was obliged to resign, and the subsequent step taken by Gerhard Schröder - the signing of a joint document with Tony Blair - apparently places the German government in alignment with British Labourism. Specifically, it temporarily banishes the doubts that exist about the possibility of conflicts arising between the ECB and the European political authorities[7], although only when the German government is actually seen to be applying measures and not merely proposing them (as its predecessor tended to do) will these doubts finally be dispelled. In short, at present and in view of the Blair-Schröder document, it seems that the line between those who seemed to be for or against a European policy of tax harmonization and the centralization of employment policies has become so blurred as to be unrecognizable. The EU seems to be evolving towards a diverse, plural system of a consensual nature, with a highly complex division of powers among the different supra-national, national and local levels. This diversity is not only institutional and economic but reflects different cultures and traditions and is, therefore, extremely difficult to alter.

Labor markets and asymmetries

Feldstein affirmed (ibid.,p 67) that, having culminated in a centralized, inflationist economic policy, the most serious consequence of the EMU would be to eliminate any room for manoeuvre in the combination and adaptation of policies to a particular situation at a national level. He also feared labor harmonization and the proliferation of conflicts caused by phenomena such as the delocalization of investment and the misnamed social dumping. In other words, he was reproducing the classic criticism of the EMU that argued, in the terms of Rudi Dornbusch (ibid.), that by abandoning adjustments through the exchange rate,

[5] *El País Digital*, 24 February, 1999, nº 1027.

[6] Oskar Lafontaine and Dominique Strauss-Kahn, "Sacar partido al euro", *El País Digital*, 28 January, 1999, nº.1000.

[7] "Europe: the third way / Die Neue Mitte", Tony Blair and Gerhard Schröder. The Labour Party.

the euro would transfer the task of adjusting competitivity and relative prices to the labor market. Given that without wage flexibility it would not be possible to carry out this adjustment process nor to avoid the accompanying losses in production and employment, the EMU would, according to this analysis, increase unemployment and social problems in the most backward regions in the long term, leading to further demands for a transfer of resources. In turn, this would generate discontent in wealthier regions, prevent a more reasonable distribution of resources and, in any case, fail to solve the underlying problem.

One general problem in discussing Feldstein's arguments is that the counter-arguments presented have to be as valid for periods when the economy is flourishing as for when it is not. Consequently, we have to admit that our objections can, as yet, be considered of limited value given that they are based only on the euro's initial success. The question will have to be re-examined when the circumstances are less favorable. As things are, it has to be admitted that the gravity and urgency with which such considerations should, in principle, be treated, have diminished owing to the relatively favorable economic cycle at the present time. It is also true that the worst manifestations of the effects of the *status quo* on the EU appear to be confined to regions that could be considered as politically invisible; to the extent that it would be politically incorrect to question either the institutional and cultural designs that seem to prevail in them or the public policies of assistance of which they are the object (by this, we are referring to those regions of Spain, Italy, Portugal, Greece and Germany that endure extraordinarily high rates of unemployment and are highly dependent on external subsidies).

To this must be added the perpetual problem of what we could call "the management of asymmetries". Structural asymmetries, in particular, refer to the existence of significant differentials between the economic cycles of the member countries in the euro zone. They raise the problem, for example, of how to adjust the same economic policy in order for it to operate efficiently in an Ireland that is expanding rapidly and an Italy and a Germany approaching stagnation or hypothetical deflation. In the Spanish case, it appears that, thanks to the prospects of stability, low inflation and cheap credit that the euro offers to the economic agents, the country is in a position to mobilize the resources that our extremely high rate of unemployment requires, and to initiate sustained growth over and above the European average for the next seven to ten years. However, Spain has an inflation differential of one point, partly because her rate of growth is increasing the pressure on prices. At all events, the questions raised are: is economic growth in the medium term compatible with relatively high inflation (especially for manufactured products that compete abroad) that could eventually threaten job creation and, therefore, growth? How can the monetary policy of the ECB be calibrated? What alternative instruments are available to prevent a single monetary policy from crippling countries with different cyclical requirements?

The management of cyclical asymmetries is a particularly delicate matter. What are called "asymmetrical shocks" will make it necessary to improvise urgent, decisive measures in the short term that we do not know if Europe will be prepared to take. As we know, what used to be Eastern Europe is a relatively safe zone for European investment: the rules of competition are those of the EU, free trade and investment protection are guaranteed, and political stability is assured largely by the prospect of entry into the EU. Latin America, in contrast, is still a long way from offering the same conditions of stability. However, Spanish companies, for example, have opted largely for the Latin American markets in preference to those of Eastern Europe. Can we imagine a situation where the Spanish stock exchange suffers huge losses, bringing down the major Spanish banking, energy or telecommunications conglomerates, owing to the political or economic instability of Argentina or Brazil? What would the consequences be to Spain and the rest of Europe? What measures could be taken? Would Europe be capable of improvising a rescue plan for a member state or a neighbouring state awaiting admission in the face of unforeseen turbulences?

Any solutions to problems of a general nature like the flexibility of labor markets, or those deriving from the asymmetries we referred to above, are hampered by the design complexity of the system of public authorities in the EU. Governments can coordinate; political families can converge; countries can share almost the same culture of economic policy; and yet, other factors intervene without which the governability of the whole cannot be assured.

Consider, for example, the importance of the *Länder* when it comes to formulating European policy in Germany. This had already become clearly visible during the negotiations of the Treaty of Amsterdam and the negotiating process of the financial prospects of the European Union for the seven years from 2000 to 2006 (the Agenda 2000). In Germany, the wealthy *Länder* flexed their muscles when they led the tax rebellion against the costs of unification. Later on, at the Inter-Governmental Conference in 1996, they blocked the change from unanimity to a qualified majority on innumerable policies with a regional content. They went on to oppose the disappearance of the German mark and the financial transfers within the EU (Cohesion Funds); and they are now spearheading the greatest threat to date: the re-nationalization of the rules on competition and the break-up of the single market. They are attempting to introduce growing degrees of discretionality into state aid policies and to seriously erode the policy of European competition. In the future they could prove a force to be reckoned with.

2. Europe as a "civil super-power"

What is conspicuous about the past year is that European construction has not altered direction as regards reinforcing the nature of the European political association. This association does not possess the nature of either a superstate, a federation in the strict sense, or a teleocratic association.[8] It continues to function as a *de facto* confederation of states that do *not* renounce, in any way, any of the last redoubts of their sovereignty, and in this (we can suppose that) they enjoy the tacit or explicit support of their political classes and public opinion (in spite of what a superficial reading of opinion surveys might lead one to believe.

The introduction of the euro is evidence of the importance of the coordinated decisions and public policies of national governments. But, additionally, it is evidence of a general orientation in the *content* of these public policies, which is none other than the discretional interventions of authority being substituted by governance by rules (interpreted as formal, abstract rules, or game rules) (Pérez-Díaz, 1998). This is the ultimate sense of the political decision to attribute supreme authority on questions of monetary policy to an independent authority like the ECB.

Once again, the début of the euro appears to challenge the opinion of those who are determined to consider Europe as a unified actor, or an actor in the process of unifying, possibly under joint Franco-German leadership. This obsession with finding a hard core within the whole overestimates the power of those countries, while forgetting the actual or potential importance of countries that, though apparently peripheral, are of far greater importance for the kind of influence in the outside world than Europe may have in the long term; these include countries like Great Britain and Ireland, Spain and Portugal, Italy, Poland and Hungary, or the Scandinavian countries.

The greatest difficulties in the coordination of public policies have arisen in the sphere of foreign policy. This is logical, given the determination of many European countries to go ahead with their own agenda in this sphere, and the nature of some of the present challenges like the conflicts in Bosnia and Kosovo. In spite of this, steps have been taken to improve coordination of these policies, always within the framework of NATO, and to redefine the objectives of foreign policy. In this sense, the idea that the main responsibility of Europe in this field is based on its contribution to the creation of a broad civil space throughout the continent, and beyond, appears to be gaining ground. However, the crucial step to achieve this objective must be consolidation of the process of incorporation of the old Eastern European countries into the EU; and the lack of progress over the last year has been disappointing.

In short, we believe that the ongoing process demonstrates that there is a certain confusion in how Feldstein and many other observers on both sides of the Atlantic view the process of European construction. They tend to think that they are witnessing the emergence of a superpower onto the world stage when, in reality, that is not the *telos* implicit in this process. The political union that is taking place corresponds to a supra-national community that does not, however, appear to go beyond a fragmentary State. It has a state apparatus located alongside those of the so-called national States (although, strictly speaking, many of them are pluri-national) whose basic function is to try and guarantee the prevalence of an order of freedom on a European or Pan-European scale. This means that, in terms of world power, Europe

[8] See Pérez-Díaz (1999a and 1999b).

classifies as a *soft power*. Any projection of its power in the world at this time, if this is ultimately quantified in military terms, is only conceivable within the framework of NATO and in association with the United States (except in the extremely unlikely event of fundamental changes in its form of government and public opinion).

The avatars of foreign policy and security

The facts appear to speak for themselves: at this time, the European Union comprises 31% of world production and 20% of world trade, while the United States comprises 27% of world production and 18% of world trade (Bergsten, ibid., p.83). Can these magnitudes be transferred to international relations? And if so, will the doves give way before the falcons? Feldstein appears to fear so (ibid., p.61) when he predicts a strong, united, assertive Europe in the international sphere, that is also protectionist and egoistic.

On assembling for the launch of the euro in January, 1999, many, on both sides of the Atlantic, then exclaimed: "and now for political union!"[9] In the United States, Feldstein (ibid., p 60) seemed convinced that the "the more fundamental long-term effect of adopting a single currency would be the creation of a political union, a European federal state with responsibility for a Europe-wide foreign and security policy as well as for what are now domestic economic and social policies". Nothing less than a super-state that, with those characteristics, could be no less than a superpower.

Yet again we must contradict Feldstein, because this time his expectations of the power and determination of Europeans on matters concerning foreign policy and security are perhaps a little too high.[10] It is indeed the hope of many fervent Europeanists that the euro will lead to political union, via preliminary unity on matters of foreign policy and security. Nevertheless, it should be remembered that forty years of incrementalism are rather more than just a tendency: they reflect a culture and an identity, a highly institutionalized *ethos* and *pathos*, a *telos* implicit in the process, and a determination to exist *in a particular way*. To imagine that the euro will lead to political union, and that this union will be a centralized superstate with a global geopolitical vocation and, consequently, capable and/or desirous of measuring itself against the United States, is more than just "going too far"; it is to ignore some of the basic facts of European experience. For example, the EU does not correspond to either an original contract between its peoples, or to an act of *force majeure* imposed by some of them upon the others, or to a process comparable to the secular process of formation of the nation states. That the European experience has little to do with the experience of the United States is too often ignored on both sides of the Atlantic. There is not enough space available here to justify this assertion nor is it the moment to do so. However, the lack of concordance between the representation of functional and territorial interests and its dispersed, superimposed, non-coincidental, fragmentary nature make the European Union an entity that is beyond the nation state, not above it.[11]

We have to look no further than the events in Bosnia and Kosovo to see the difficulties the EU has in articulating a foreign policy that contemplates the use of force in a rapid and efficient way. Without analyzing these conflicts, it is enough to remember, in the case of Kosovo, the problems that the EU, the United States and NATO had to maintain a consensus on a campaign that, *a priori* constituted a modest enough challenge: an aerial campaign without casualties, in European terri-

[9] Among them, the ex-president of the Bundesbank, Hans Tietmeyer. See *El País Digital*, 10 May, 1998.

[10] However, it would not be fair to ignore the fact that this is a minority view even among the sceptics. Even for Dornbusch, the EMU "is not the first step from which political union will naturally follow" (ibid., p.120). As Dornbusch points out, in contrast to the *political* nature of integration on questions of foreign relations, security and defence, the renunciation of monetary sovereignty should be interpreted as an act of depoliticization, equivalent to "kicking a bad habit" (p.121, which is obviously inconceivable as regards political union. Monetary stability is a universal concept today, whereas what each country understands by peace and security is not.

[11] The non-coincidence of the participants is the most obvious limitation for analogical thinking. Consider that when the national currencies disappear in July, 2002, the European Union will (probably) be composed of an area of free trade made up of nearly thirty countries; an area of monetary unity made up of 13 participating members (the 11 of the euro zone, Greece and the United Kingdom); an area of justice and home affairs comprising 15, excluding Denmark and the United Kingdom; and an area of defence comprising a different 15, excluding Sweden, Ireland and Finland. This is an "order" that will become considerably more complicated when it expands to include the East.

tory, against a clearly inferior adversary with no external support. All that was achieved by the mobilization of so much manpower was the retreat of the Serbian troops from an enclave where the Serbian population was in the minority, little more than a token presence. Meanwhile, Milosevic continues in power, the Serbian army is intact, the quasi-Kosovar state is an unknown quantity, and NATO is a long way from having the situation in the area under control.

Ostensibly, it seems that Europe should have learnt the lesson that it needs greater power and ability to conduct a defence policy. Or perhaps it has only received the lesson that it still has to learn. But only learning the lesson is not enough: it also requires the determination to apply it on the next occasion, and this is precisely what Europeans appear to lack. We feel that perhaps the lack of this kind of "iron will"· is where the "essence" of the European project resides (for the present).

It is not a question of whether there have been institutional advances. In the areas of Common Security and Foreign Policy (CSFP) there certainly have been. In fact, in the Treaty of Amsterdam and in the agreements reached within the Western European Union, the EU has a formidable capacity for action within its reach. Institutionally, a qualified majority and constructive abstention should be enough for the five major members (Germany, France, the United Kingdom, Italy and Spain) to get round the objections of the neutral members (Finland, Sweden, Austria and Ireland) and the wayward member (Greece), and they should be able to incorporate the rest of the smaller countries (Belgium, Holland, Denmark, Portugal and Luxembourg) into a broad consensus. In fact, looking back, the advances recorded since European Political Cooperation (EPC) was set up in 1970 have been remarkable. However, institutional integration has already reached its limits: even if the WEU were to become the military arm of the EU, and even if the latter managed to replicate a miniature NATO, the Fifteen would have no guarantee of unified action.

We believe that this is reasonable. It certainly reflects European diversity and plurality. Therefore, a formal political union may be possible but, as in the case of Kosovo, we shall probably continue to witness how a coalition of the "most powerful countries on earth" hesitates and suffers when it comes to forging and upholding the consensuses that are necessary on matters of security. The situation is not exceptional. With the United States in mind, Tocqueville stated that "It is especially in the conduct of their foreing relations that democracies appear to me decidedly inferior to other governments"[12]. Although there is room for a great many nuances in such an affirmation and its assumptions have been widely argued over, the basic intuition behind that statement is that the multiplicity of actors who intervene in the formulation of foreign and security policy in a democracy (the press, public opinion, political parties, parliament) tends to impede the attainment of objectives in the long term and the capacity of the executive power to isolate itself from sectorial pressures. This results in a weak, short-sighted, reactive foreign policy. The counter to this claim is, naturally, the reminder of how democracies have been able to defeat two totalitarianisms militarily: first the Nazis and then the Communists (the latter, by means of bringing it to ruin and collapse from within). This was despite the fact that the totalitarian governments had apparently unlimited energy, no scruples, an infinite amount of skill and cunning in the use of force, a long-term vision of history and other grandiose characteristics of a similar nature.

It is not difficult to imagine that a Union of the Fifteen, soon to become Twenty-Five, members, with multiple levels of government, will encounter difficulties when it comes to formulating and executing an active security policy that goes beyond the mere defence of its borders. Although it may seem paradoxical, in our opinion one can be optimistic and still maintain that Europeans can use their own limitations to their benefit. Perhaps it would be useful for them to accept the idea that it is unlikely that political union would result in a federation, or the latter in a European army. Nevertheless, Europeans will still share an increasing number of security resources, just as they will continue to decide by consensus, from a mixed national and European viewpoint, what to do with them on a case by case basis. Therefore, in relation to the outside world, rather than repeat the "republican-imperial" experience of the United States, Europe seems destined to become a *civil superpower*, a civilizing force (which includes the elements of force necessary). As such, it is possible that it may contribute to modifying, perhaps profoundly modifying, the nature of international relations.

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[12] See Joffe (1988).

The challenge is enlargement to the East

In our opinion, the most serious challenge facing the process of European construction, once the euro is firmly established, is not political union but its enlargement eastwards. This is because it will be the ultimate test of Europe's ability to progress towards becoming the kind of "civil superpower" to which we referred above. Today and over the next decade, Europe will be gambling on the historic possibility of extending its space of peace, freedom and security to the more than one hundred million inhabitants of Eastern Europe who have decided to become participants in the process of European construction. They have interpreted it (correctly) not as the realization of a project drawn up by visionaries, but as a complex, protean and somewhat confused project that continues to muddle through. Within it, Europeans will find themselves conversing with one other, deciding freely on the future without dramatism (or exaggerated pretensions) and, above all, without irreversibly mortgaging the scope of their freedom of action (even in foreign policy) or their identity.[13]

In reality, it is an open secret that enlargement is not going too well. Formally, it is proceeding according to plan, because a number of important targets have been met since 1989. Between 1991 and 1996, ten countries in Eastern Europe signed association agreements (European agreements) with the European Union. As a result of these agreements, there already exists what is basically an area of Pan-European free trade. In 1993, at the European Council in Copenhagen, the 12 members of the (then) European Community promised entry to the Eastern European countries that fulfilled the corresponding political and economic requirements. Since then, at the European Council in Essen, a strategy of preaccession was set up, accompanied by a stability plan for minorities (Plan Balladur). In the White Book of 1995, the EU detailed the necessary legislative reforms that the candidates would have to introduce, and at the European Council in Madrid, in December of the same year, the Fifteen drew up an open, evolutionary process of admittance that was non-discriminatory between candidates. After the favorable verdicts of the European Commission, published in July, 1997, six countries (Poland, Hungary, the Czech Republic, Slovenia, Estonia and Cyprus) opened formal entry negotiations on 30 March, 1998, while a second group of countries (Slovakia, Rumania, Bulgaria, Lithuania and Latvia) remained subject to annual revisions of their suitability for incorporation into the initial negotiating group.

How does one explain that the targets are being met but that enlargement is not going well? Essentially, because there seems to be a rift between the "geo-political, historical and moral imperatives" on the one hand, and "economic, institutional and budgetary realities" on the other.

The former have been pointing clearly in one direction since 1989, while the latter have been pointing in the other.

As we know, the Inter-Governmental Conference of 1996, whose leitmotif was specifically one of preparing the Union for enlargement, was a patent failure when it came to articulating the institutional reform that has to precede it. In its place, the Fifteen decided to undertake a reform of minimums (limited to the voting rules in the Council and the number of commissars) and to postpone it until the last minute.

The budgetary problems of enlargement were apparently solved by the Agenda 2000, but in fact, at the European Council in Berlin in March, 1999, the measures agreed by the Fifteen referred to their own budgetary needs and limitations and not, strictly speaking, to those of the candidate members. The Eastern economies have actually been progressing with difficulty, partially for their own internal reasons but partially because of the uncertainties associated with the situation of their neighbours further to the East and to the South. Furthermore, the conflict in Kosovo has brought into the open an enormous amount of confusion about the borders of the European Union, and it has insinuated the possible admission of all the Balkan countries into the EU in the future. The European Council in Helsinki in December, 1999, will, moreover, be proposing to admit Turkey to the official list of candidate countries for membership.

[13] See Garton-Ash (1998).

In these circumstances, it would be extremely serious, though perfectly possible, that enlargement merely became a routine objective, empty of any real content. How? By the establishment of long periods of transition; the degradation of the extent and depth of political and financial commitments; and, in short, the constitution of a "second-class Europe" whose misfortunes would be contemplated by the rich, secure, free Europe of the euro with apparent compassion, gestures of concern and profound indifference.

The limits of determination

It is not possible to find a solution to the challenges of enlargement and a foreign and security policy by willpower alone. It is essential to start out from a realistic and reasonable understanding of the ongoing process, of the complexity of the institutional design, of the actual experience of a mosaic of national states, and of the extremely dense networks of exchanges, communications and influences. All this is incompatible with simplifications. Feldstein is afraid of a European superstate that centralizes and extols a European social model of high social spending, inflation and unemployment in domestic affairs, while becoming a force that is economically protectionist and diplomatically assertive in foreign affairs. In answer to this, we would resort to paradox and argue that Europe lacks sufficient politico-institutional flexibility to achieve such a rigid result.

In our opinion, parallel to the (external) challenges that face Europe as regards enlargement and security, the real internal challenge posed by the euro is whether the EMU will serve to accelerate the unavoidable structural reforms or whether its early success will, on the contrary, serve as an alibi for deferring them yet again. In other words, does 1st January, 1999 represent some initial signs of maturity on the part of the European political class and national public opinions in their attitude towards making greater demands on themselves? Or does it mark a time for settling accounts, an opportunity for the political class to promote their exclusively partisan interests amidst the perplexity and irresponsible passivity of the general public?

There is a debate waiting to happen in Europe on the sustainablity amd viability of its social, economic and political model that the relative, initial (and provisional) success of the euro should not be allowed to obscure. However, there are no simple answers, and the European public sphere has serious failings. On the one hand, after two decades of predication and example, the basic idea of the need for structural reforms seems to be making headway in the social democratic ranks (the "Third Way" of Blair and the "New Center" of Schröder) that have traditionally been the most reluctant in this respect. The Treaty of Amsterdam, described by some as "Blairite" owing to its emphasis on reforms and the creation of employment by means of deregulation, together with recent events like the resistance to tax harmonization and the Blair-Schröder document in the spring and summer of 1999, tentatively suggest that the European social democrats are finally getting over the idea, that had dominated their thinking throughout the eighties, of a resuscitation of the welfare state at a European level. However, not even the definitive triumph of this new paradigm among social democrats can be taken for granted. A hundred years after Bernstein, the liberal component of this new version of the ideas of social democracy has still never been fully developed. This demonstrates that, however well-concealed they are, its *dirigiste* ambitions continue to be essential to the left (or the center-left). This is most visible in the case of France, although almost certainly the crux of the problem is not in France but in Germany.

Germany as a metaphor

What is interesting about the German case is that it demonstrates how the terms of right and left, or even the center-right versus the center-left, are relatively secondary to the nature of the European political discussion. If Germany has spent the last decade immersed in a confused debate about her position in the world, this owes about as much to the social democrats as it does to the christian democrats. Underlying their disagreements, there has been a profound political consensus between these two political formations; and even the most diverse social forces have shared in this consensus, including unions and sizeable business interests.

The debate combines elements of politics, security, economics, history and ethics. Above all, it reflects on a far from easy actualization of Germany's collective identity. Until this is settled, German "capacity for leadership" (in the weakest but most important sense of the term) will suffer, either because of its clumsiness and inexperience as it tries to exercise its new-found responsibilities and examine its possibilities, or because the historical framework has altered and made established practices obsolete. Historically, from the Weimar

Republic to the “great policy” of Konrad Adenauer and Helmut Kohl, and to the Congress of Bad Godesberg and Ostpolitik, the German ability to adapt is beyond question. However, adaptation is a slow process that Germany, like a huge vessel that takes time to alter course, undertakes very gradually and on few occasions.

But it is true that *de te fabula narratur:* the European Union is very similar to Germany in this sense. In both the European and the German case, the solution is probably not to cherish nostalgia for the “great helmsman”, this time under the banner of leadership of this or that segment of the political class. The solution is to know how to live in an order of freedom that will uphold and confirm a complex, open, cautious system of public authorities, who are restrained in their interventions and, hopefully, do not suffer from delusions of grandeur.

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