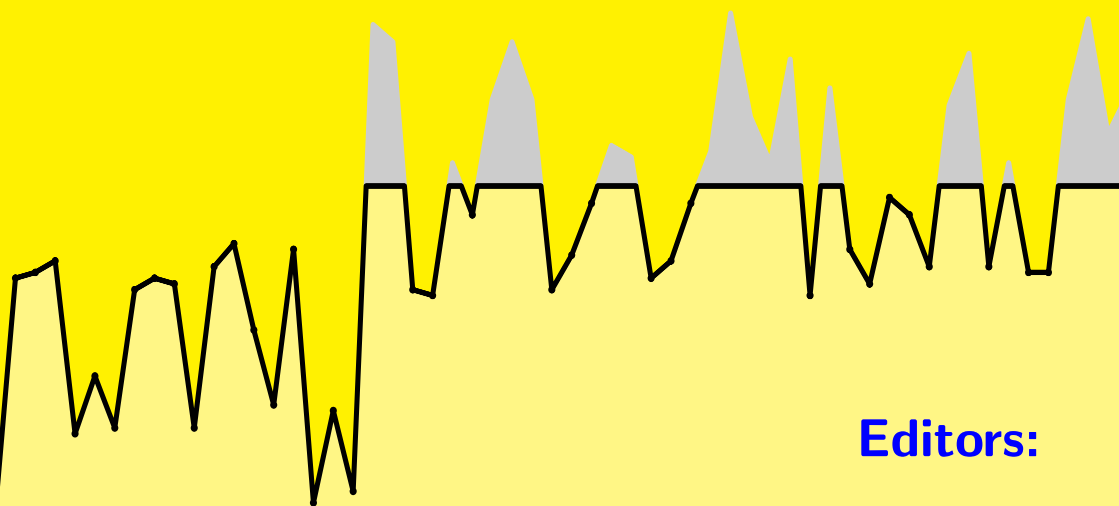
# Political Economy of Eurozone Crisis

## Reforms and Their Limits



Editors:

Lubor Lacina
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2013

# POLITICAL ECONOMY OF EUROZONE CRISIS

# REFORMS AND THEIR LIMITS

Lubor Lacina
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(editors)

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**Political Economy of Eurozone Crisis**
**Reforms and Their Limits**


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# Introduction

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The proposed volume explores the recent economic dynamics of the European common currency area (Eurozone), the underlying trends and economic policies. The emphasis is placed on the evaluation of the recent economic crisis, steps taken to address it and the policies designed to move beyond the crisis.

Eurozone (and implicitly the whole EU) finds itself at the crossroad. Economic dynamism of the last few years revealed fissures in the European economic and increasingly political edifice. The vaunted achievement – the common currency euro – proved itself to be the double-edged sword. The common currency certainly contributed to the increased integration both in the real and the financial sectors. However, in the presence of the persistent differences between the "northern core" and the countries on the Mediterranean littoral, this enhanced integration acts more as an undesirable weight and obstacle rather than the dreamed about engine of progress.

Because the costs of "un-integration" are perceived to be prohibitive, the EU – and especially the Eurozone – are forced to seek common, cooperative solutions. In practical terms, the alternative to the Eurozone's restructuring and (at least partial) return to national currencies is seen in steps toward the increased "fiscal" integration (fiscal union) and the "banking union". However, the recently intensified discussion indicates the lack of a common understanding of these concepts. Several different variants of each are advanced, which is certainly not instrumental in reaching the consensus required for practical steps.

However, the one thing appears to be obvious. Whatever the form of the fiscal and banking union(s), the transfer of resources is implicit (and seemingly necessary) for those unions if they are to provide the underpinnings for the current structure of the monetary union. This indeed

raises the question of the governance of these unions – both fiscal and monetary. After all, the provision of resources implies an allocation – and it is hard to imagine that resources will be provided to the common pool (i.e. to the fiscal and banking union) unless the provider has some say with respect to the allocation of those resources. And that requires some form of common (i.e. centralized) decision making procedures, in all likelihood exceeding the common understanding of Acquis communautaire as it exists today – i.e. some form of the effective political union.

Given the significant political content in deciding about taxes, expenditures and resource transfers (i.e. the fiscal and banking unions), some mechanism of the political governance involving the democratic processes appears to be necessary for these unions.

Contributors to this volume were selected to analyze various aspects of the processes of the Eurozone governance reform and (desirable) the growth. They provide balanced and multifaceted look at the Eurozone's dynamics since its inception in general and in the last five years in particular. The issues analyzed include the discussion of the Eurozone dynamics, growth and reform, dilemmas associated with fiscal and banking unions and the interplays between the economic, legal and political. (More details are in the list of contents with abstracts bellow.)

The basic idea which connects all contributions is the analysis of the problems which affected the Eurozone in the past decade and the challenges and dilemmas the Eurozone will face in the coming years.

The book is divided into 10 chapters in three parts. The first part analyzes the issues associated with the exit from economic crisis and the return to economic growth. It includes four chapters.

In the first chapter Karl Aiginger, Matthias Firgo, and Peter Huber from the WIFO Institute in Vienna, Austria, discuss the lessons the "peripheral countries" of the Eurozone could learn from the analysis if the regional growth. They show that the experiences of 259 regions in 21 European countries with within country GDP per capita and labour productivity growth suggest that in a variables associated with pro-active, growth oriented strategies are consistently more important predictors of successful regional development than variables related to austerity for a range of measures of successful development. Since regions are the only historical examples of restructuring in currency unions, we therefore also argue for a more growth oriented strategy to solve the problems of the European periphery and outline some features of such a strategy.

In Chapter 2 Antonin Rusek from Susquehanna University in Selinsgrove, USA analyzes the Eurozone crisis and its stabilization and possible solution. He points out that the Eurozone (and implicitly the whole EU) finds itself at the crossroad. Economic dynamism of the last few years revealed fissures in the European economic and increasingly political edifice. The vaunted achievement – the common currency euro – proved itself to be a double-edged sword. The common currency certainly contributed to the increased integration both in the real and financial sectors. However, in the presence of the persistent differences between the "northern core" and the countries on the Mediterranean littoral, this enhanced integration acts more as an undesirable weight and obstacle rather than the dreamed about engine of progress. Because the costs of "un-integration" are perceived to be prohibitive, EU – and especially the Eurozone – are forced to seek common, cooperative solutions. In practical terms, the alternative to the Eurozone's restructuring and (at least partial) return to national currencies is seen in steps toward the increased "fiscal" integration (fiscal union) and "banking union". However, the recently intensified discussion indicates the lack of the common understanding of these concepts. Several different variants of each are advanced, which is certainly not instrumental in reaching the consensus required for practical steps. However, the one thing appears to be obvious. Whatever the form of the fiscal and banking union(s), the transfer of resources which is implicit (and seemingly necessary) for those unions if they are to provide the underpinnings for the current structure of the monetary union. This indeed raises the question of the governance of these unions – both fiscal and monetary. After all, the provision of resources implies an allocation – and it is hard to imagine that resources will be provided to the common pool (i.e. to the fiscal and banking union) unless the provider has some say with respect to the allocation of those resources. And that requires some form of common (i.e. centralized) decision making procedures, in all likelihood exceeding the common understanding of Acquis communautaire as it exists today – i.e. some form of the effective political union. Given the significant political content in deciding about taxes, expenditures and resource transfers (i.e. the fiscal and banking unions), some mechanism of the political governance involving the democratic processes appears to be necessary for these unions. That then requires the discussion of the following interrelated questions: What is the minimum requirement for fiscal and banking unions to preserve and support the some form of the monetary union (i.e. to preserve Euro)? What kind of political governance could support there require-

ments? If the acceptable answer to these questions cannot be found, the future of the European experiment is indeed, "in doubt".

Grigoris Zarotiadis from the Aristotle University in Thessaloniki, Greece discusses the EU's recent transformation from the new-Keynesian co-operation to the neo-liberal monetary Union in Chapter 3. He asks how did a period of convergence result into a period of diverging per capita income and deepening inequality in the member states? Why "price equalization" occurred prior to the equalization of income? How did the "European Acquis" for democratic legitimization convert into decisions taken by the majority of the participating funds (for instance in case of ESM)? For him the answer to these questions relates to the analysis of inflation-phobia and the justification of the neo-liberal "corset". Specific policy alternatives are discussed, as well as proposals for further relevant inquiries.

The Part I concludes with the contribution of Christian Fahrholz from the Friedrich Schiller University in Jena, Germany, and Cezary Wojcik from Warsaw School of Economics in Warsaw, Poland, who argue the need for the Eurozone's exit rules in Chapter 4. With the sovereign debt crisis spreading across Europe, there is no shortage of suggestions on how to save the Eurozone. This chapter says the exit rules are the silver bullet. It argues that exit rules would decrease the probability of a break-up of the Eurozone by enhancing market discipline, increasing the political bargaining power of EZ members vis-à-vis the profligate countries, enhancing internal discipline in the profligate countries, and reducing market uncertainty.

Part II addresses the dilemmas of Eurozone reforms. Carsten Colombier from University of Cologne, Germany, analyzes the national debt breaks as they relate to fiscal union in Chapter 5. He shows that the introduction of national debt brakes in the member countries of the EMU can have a double dividend. Not only proves a debt brake beneficial in terms of sustainable public finances but can also contribute to a convergent development in the EMU under certain conditions. Due to the ongoing crisis, several reforms have been implemented at the EU-level, which are tilted to strengthening the budget discipline of EMU countries. These reforms underlie the view that government profligacy is the main culprit of the crisis. However, several economists emphasise that the EMU is an incomplete currency union. As a result, in the pre-crisis years massive external imbalances in the EMU have been built up. This chapter shows that a debt-brake rule leads to lower current-account deficits in a boom

phase. This is because automatic stabilisers are allowed to work properly. Additionally, it is less probable that the working of automatic stabilisers is counteracted by pro-cyclical fiscal policy. Overall, a debt-brake rule does not maintain a sufficient insurance against divergent developments in the EMU. For this other measures such as a delegation of fiscal powers to the union level are necessary.

In Chapter 6, Christian Keuschnigg from University of St. Gallen, Switzerland, and Klaus Weystrass from the Institute of Advanced Studies in Vienna, Austria, ask whether the fiscal union is the solution to the Eurozone debt crisis? They point out that in some Eurozone member countries, high public or private debt, respectively, has been accumulated over time. Since the first culmination of the financial crisis in autumn 2008, these countries have been confronted with high sovereign risk premiums. For some countries, financing public debt via capital markets became impossible as interest rates climbed to very high levels. These problems have forced the respective countries to implement painful macroeconomic adjustment programs. Since such reforms need time to unfold their benefits, financial assistance of the international community was necessary to prevent sovereign defaults. Hence, the temporary European Financial Stabilisation Facility (EFSF) and its permanent successor, the European Stabilisation Mechanism (ESM) have been established. Since in the course of the crisis it turned out that many European banks are weakly capitalised, necessitating large public capital injections, higher equity requirements for the European banking sector, and ultimately a banking union are currently discussed. Furthermore, further centralisation of fiscal policies, ultimately leading to a fiscal union, are on the political agenda. In the analysis which is based on Keuschnigg (2012a and 2012b) we argue that moving towards a fiscal union does not address the fundamental problems of economic divergence in Europe. Given cultural heterogeneity and diverse preferences, fiscal policy should remain under national sovereignty, while important regulatory power should be assigned to the Union. Authors argues that more credible fiscal rules combined with tighter surveillance reduce negative policy spillovers. A better capitalised banking sector imposes more market discipline with sovereign risk-premiums. Institutional lending by the ESM to distressed countries has to be subject to strict conditionality and impose structural adjustment that was neglected ex ante. In a monetary union, external devaluation via exchange rate adjustments is not available. Hence, those countries that experienced very high unit labour cost growth since the founding of the Eurozone, leading to high current account deficits, need

to adjust their wages and prices and implement other further reforms seem necessary to strengthen the financial capacity and institutional independence of the ESM and to impose tighter regulation and more ambitious recapitalisation of European banks to contain cross-country contagion on financial markets. Weakly capitalised, distressed banks require capital injections by the government, pushing up public debt. On the other hand, haircuts on sovereign debt impose losses on banks holding government bonds. To break this vicious circle requires higher equity and stricter regulation of the European banks. We conclude that a fiscal union alone is not a sufficient solution to the current debt crisis in some Eurozone member states, but elements of a fiscal union with strict fiscal rules constitute an essential part of the overall solution.

In Chapter 7, Istvan Benczes from the Corvinus University in Budapest, Hungary, analyzes the controversies of economic governance in the EU. He starts by pointing out that the well-known impossible trinity of international economics claims that countries are unable to initiate full capital mobility, a fixed exchange rate regime and an autonomous monetary policy all at the same time. One of these goals should be necessarily sacrificed in order to meet the other two. By launching the EMU project, countries of the European Union decided to fix their national currencies irrevocably and maintain full capital mobility in exchange for the delegation of their monetary policy onto a supranational level. The most recent sovereign debt crisis of the EU, however, has dramatically challenged the sustainability of the whole Eurozone. Until very recently, the EU has strongly insisted on the following three conditions: no country can leave the monetary union, no bail-out is allowed in the case of financial difficulties and absolutely no default is allowed. All three "no's" have been indispensible pillars of the European economic governance structure. The crisis, nevertheless, has mercilessly demonstrated that these three pillars are not compatible with each other in the event of a financial distress. By now it should be clear for all member states that one of these "no's" should be given up in order to tolerate the other two. Accordingly, this constraint is called as "the impossible trinity of denial". The chapter demonstrates that only by a drastic redesign of the governance structure of the Eurozone can countries re-establish the viability of the whole European integration process.

Part III contains the thoughts which go beyond the economic analysis. In Chapter 8 Lubor Lacina from the Mendel University in Brno, Czech Republic, and Lucie Tunkrova from Fatih University in Istanbul, Turkey, analyze the multiannual framework of Eurozone negotiations as these re-

late to the Eurozone's crisis. They point out that the relative size of the EU budget is fixed and there has not been any long-term support to significantly increase it above 1% of the EU's GNI. Both the European Commission and the European Parliament point to the urgent need to increase the size of the EU budget but some member states want to see a decline in this ratio. The Eurozone debt crisis could – and should – be used as an opportunity to improve the stabilization capacity of the EU budget according to fiscal federalism theory recommendations, moving the EU closer towards the last stage of the integration process, i.e. a political union. While it appears that we know what needs to be done, we also seem to know that there is no way to achieve that. To achieve this goal will be a major challenge for the EU and its member states in the near future. We argue that the current crisis opened an opportunity window that needs to be fully utilised. In this chapter authors provides an economic analysis of the scenarios with respect to the most recent regional and global economic and financial developments. We will also look at the bargaining skills and positions of the EU's institutions (Parliament, Commission, Presidency) and member states, both members and non-members of the Eurozone and the negotiations strategies of member states, and how their 'political power' can be utilized in securing favourable negotiations outcomes in the context of the new budgetary framework negotiations.

Ivo Bures from the ERA Postal Savings Bank in Prague, Czech Republic contrasts the economic efficiency with morals in Chapter 9. He starts with pointing out that the European crisis has entered the phase where the possibility of euro break-up is at the table. He try to estimate the approximate financial costs of euro break-up for Germany as a typical current account surplus country. Author is focusing solely on immediate costs resulting from the inability of peripheral countries to cover their financial commitments towards German financial institutions. He put it into contrast with the funds currently needed to be transferred from Germany to peripheries to finance their current account balance adjustment. Author ignores further potentially severe costs of euro break-up for German economy, such as severe damage to the free move of capital and goods within the EU as well as much more restrictive monetary policy. Based on that approach, he concludes that from economic point of view it is not rational to opt out of euro for Germany. On the other hand he try to argue that with democratic institutions in place, It can be challenging for German politicians to advocate euro-membership solely on the basis of the threat of more costly alternatives. If you look at the

value formation process within any country, not only utilitarian logic of maximum gain and minimum pain is at place. Libertarians and other theoretical approaches say that (economic) consequences are not all we care about when we are judging moral legitimacy of actions and policies. That is why people from surplus countries can easily turn against the intra-EMU transfers, necessary for the adjustment of peripheral economies and euro survival as well. Author point is that economically inefficient euro break-up can be chosen by democratic societies such as Germany without any coordination or behavioral failures, but solely because of prioritizing other than economic values.

Ivo Slosarcik from the Charles University in Prague, Czech Republic, concludes the Part III with Chapter 10, titled Fiscal Compact: Run Away from Lawyers? He stresses that The Fiscal Compact, agreed by 25 EU states in 2012, has been analyzed primarily from the economic perspective. However, legal aspects of the Fiscal Compact also deserve proper academic analysis. The Fiscal Compact suffers from lack of legal elegance, insufficient normative predictability and obscurity of its relation with the rest of the EU legal order. One explanation of these weaknesses is the fact that the Fiscal Compact itself was drafted, under severe time pressure, as ad hoc solution after collapse of negotiations aimed at formal amendment, albeit by means of simplified amendment procedure, of the Lisbon Treaty. Legal shortcomings of the Fiscal Compact have potential to weaken the efficiency of new intended regulatory framework of the EU/Eurozone as well as they may enhance risk that the Fiscal Compact could collide with the EU law or constitutional laws of member states. However, legal weaknesses of the Fiscal Compact can be also rooted in the intention of its drafters to minimize legal constrains for future EU/Eurozone actions; thus to avoid a scenario similar to the Eurozone's experience of years 2010–2012 when the EU/Eurozone activities had to cope with normative restrictions (such as "no bail-out clause") contained in the Lisbon Treaty. Primarily, chapter will map and attempt to contextualize problematic legal issues of the Fiscal Compact. In particular the following issues will deserve a specific attention: "voting cartel" of Eurozone states expected under the Fiscal Compact (art. 7), involvement of the Court of Justice of the European Union (art. 8), obligation to activate art. 136 and 326–334 SFEU (art. 10) and/or plan to incorporate the Fiscal Compact into the EU Treaty framework within five years deadline (art. 16). As the secondary objective, the chapter will attempt to answer a question whether legal concerns played significant role in Czech refusal to join the Fiscal Compact or whether Czech legal

objections served only as a “fig-leave” for a politically and ideologically motivated opposition to this European initiative.

Epilogue concludes the volume. Antonin Rusek looks back at the steps take to “save” the Eurozone (i.e. the common currency). He stresses the necessity of the continuing reforms. Simultaneously, he points out at the dangers of ad hoc responses and “as we go” changes. Abandonment of basic principles embodies in treaties establishing the EU is the recipe for chaos. And the chaos can be responded to only in two ways. One is the re-assertion of national sovereignties – i.e. the end of the Eurozone. Alternatively, the dictatorship might be established on the European level. EU would be preserved but the dream of the freedom and liberty would die. The choice is open.

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# I

# Exit from the Crisis: Reforms and Growth

# 1 What Can the EMU's Peripheral Countries Learn from Regional Growth?

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## 1.1 Introduction

The recent financial and economic crisis has drawn renewed attention to the substantial national and regional disparities in competitiveness in the European Monetary Union (EMU). After a bumpy but successful catching-up of the periphery countries in the last decades, several southern European countries faced a severe setback, leading to twin deficits in the public sector and the current account. This led to these countries becoming a drag on stability and growth in Europe, with high unemployment and low growth. Many authors (e.g. Aiginger, 2013, Bertola, 2013) have noted the role of low levels of labour productivity, high unit labour costs, and large current account deficits leading to the current economic problems of some of the peripheral EU countries such as Greece, Portugal and Spain (the P3), as well as the challenges the development of these countries poses to both European cohesion and the monetary union. The response of policy makers and advisors to these challenges – based on the experiences in other countries – was to call for reform programs that aim to re-establish competitiveness and budgetary control through a combination of expenditure cuts, internal devaluation and institutional reform. These programs were successful in reducing balance of payment deficits and unit labour costs in the P3, but have not succeeded in reducing budget deficits and government debt and have also resulted in negative growth and soaring unemployment in particular youth unemployment rates in the countries affected (Aiginger et al., 2012).

In this chapter we argue that, while re-establishing competitiveness and regaining control over the budget and public debt is indeed paramount to solving the problems of the P3, the fact that they are members of the European Monetary Union (EMU) adds complexity to the task of designing appropriate strategies. This arises because first of all, in a currency union individual countries, by definition, cannot devalue their currency. Second of all, because in a monetary union important interdependencies

in terms of relative competitiveness exist between the centre and the periphery and third of all, because in contrast to solitary states monetary unions are also typically characterized by multi-level governance issues. One consequence of this is that standard national reform programs using devaluation strategies to regain competitiveness are likely to have high social and political costs, because the only way such countries can devalue in currency unions is through internal devaluation (i.e. wage restraints).

Policy makers could probably be better advised if historical experiences of successful restructuring of countries within a currency union were available. This is, however, not the case. We therefore turn to the experiences of regions within countries as the only historical examples of restructuring available in a currency union and ask first of all what were the main predictors for regional development in lagging regions in national currency unions in the last two decades and second of all what can be learned from their experiences for the potential reform strategies in peripheral countries of the EU. Using data on 259 regions in 21 European countries, two measures of welfare and competitiveness (GDP per capita and labour productivity) and three measures of successful development, we find a marked difference between the factors that predict successful regional catching-up to country averages and the current policy prescriptions to periphery countries. Variables that are associated with pro-active growth oriented development strategies (such as education and productive investments) are consistently more important predictors of successful catching-up both for GDP per capita and productivity than variables that are related to strategies focusing on internal devaluation or austerity (such as unit labour costs). In our conclusions we therefore argue for a more growth oriented strategy to solve the problems of the European periphery and outline some features of such a strategy that could augment current austerity based policies.

## 1.2 European Convergence Experience 1991–2009

The data we use were collected from the Eurostat, OECD and Cambridge Econometrics databases for 259 NUTS 2 regions in the 21 EU countries with two or more NUTS 2 regions and excluding overseas regions of France and Portugal (due to a lack of data) for the period from the reunification of Germany in 1991 to 2009. We use data on real GDP per capita (based on year 2000 prices), wages (compensation per employee)

as well as on productivity (i.e. GVA per employed) from the Cambridge econometrics database as an indicator of regional development.

Figure 1 presents some evidence on the development of regional disparities in Europe in the last two decades taken from this data, by reporting

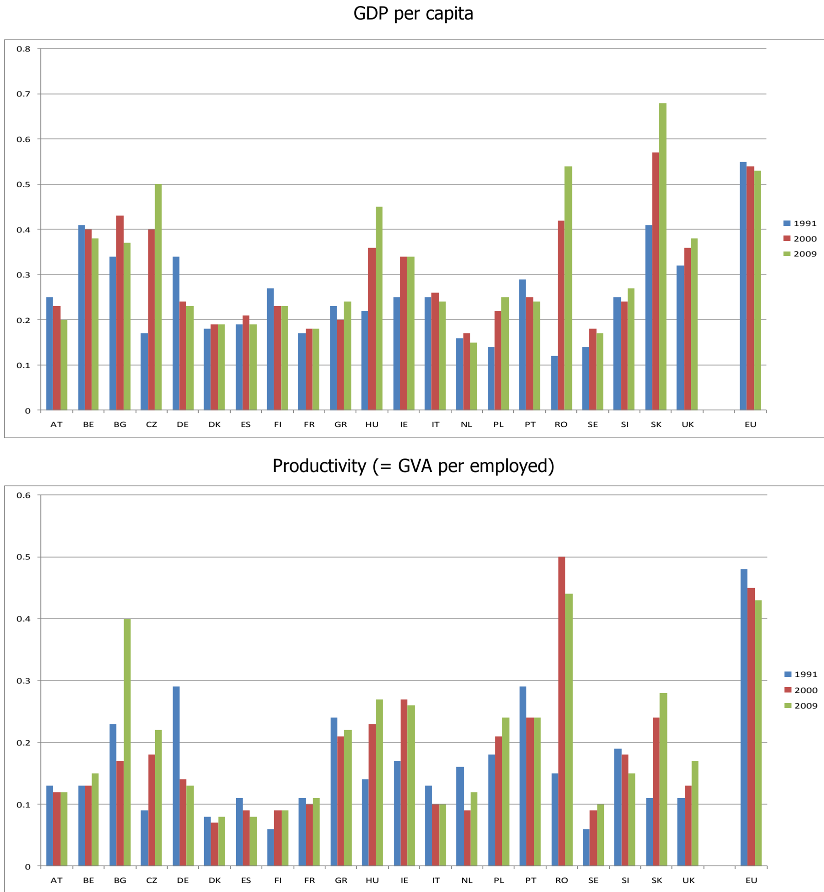



**Figure 1 Coefficient of variation in GDP per capita and labour productivity across NUTS2 regions of the EU countries (1991, 2000, 2009)**

Source: Eurostat, OECD, CE.

the coefficient of variation[1] of our two variables of interest for three points in time. As can be seen across all EU regions modest convergence prevailed in both variables in the time period considered. The coefficient of variation in GDP per capita among all EU regions fell from 0.55 to 0.53, that of productivity from 0.48 to 0.43 and that of compensation per employee from 0.58 to 0.48 between 1991 and 2009. This EU-wide convergence, however, seems to have been primarily carried by cross-country convergence and there is a huge variation among countries in terms of convergence and divergence in the two decades analysed (see also Crespo-Cuaresma et al., 2011, 2012). Among the EU-member states that joined the EU in 2004 and 2007, regional disparities within countries increased in all indicators at all points in time in the Czech Republic, Hungary, Poland and Romania. Among the EU-15 countries as well as Slovenia and Bulgaria all countries experienced at least one period of divergence for at least one of the variables considered. The only country where convergence applies to both indicators in all periods is Germany. While convergence in the EU progressed slowly but steadily over the last two decades, therefore, convergence within countries has been rather bumpy and far from ubiquitous.

Furthermore, convergence has also differed substantially over time periods and indicators. While the coefficient of variation in GDP per capita converged in only 7 countries between 1991 and 2000 but in 11 between 2000 and 2009, the opposite applies to productivity. Here 11 countries converged between 1991 and 2000 but only 5 between 2000 and 2009. This highlights in particular the 2000's as a period of divergent productivity but convergent GDP per capita in many countries. This could potentially have given rise to macro-economic imbalances such as those found in the P3 countries, in many regions.

The heterogeneity among EU countries in convergence experiences over the last two decades, becomes even more compelling when considering individual regions. To highlight this we calculated three measures of region specific convergence and divergence in the EU. In the first of these we follow Faini (2003) and (for each country and time period) divide regions into four groups, depending on, whether they had GDP per capita or productivity levels below or above the median of the respective country at the beginning of a period, and on whether their average growth

[1] We give preference to the coefficient of variation (i.e. the standard deviation relative to the average) as a measure of dispersion, because it is has no dimension and is therefore less sensitive to the scale of measurement.

in these variables was above or below the respective country's median throughout the period. This gives us four types of regions:

- Regions with below median levels of GDP per capita or productivity at the beginning of the period that grew below the national median in the subsequent period (poor diverging regions).
- Regions with below median levels of GDP per capita or productivity at the beginning of the period that subsequently grew above the national median (poor converging regions).
- Regions with above median levels of GDP per capita or productivity at the beginning of the period with growth below the national median after this (rich converging regions).
- Regions with above median levels of GDP per capita or productivity at the beginning of the period that grew above the national median (rich diverging regions).

To construct the second measure, by contrast, following for instance Quah (1996), Le Gallo (2004) or Bosker (2009) we sort all regions of a country in an ascending order and assign the regions to two groups according whether their rank within the country was below or above the median in the years 1991, 2000 and 2009, respectively. Based on this division, we then consider those regions which moved between the lower and the upper half of the distribution of GDP per capita or productivity between two periods of time. In this way we are again able to define 4 types of regions:

1. Regions which started in the lower half of their country's distribution in the first period and stayed in the lower half (permanently poor regions).

2. Regions which started in the lower half of their country's distribution in the first period but moved up the distribution (upwardly mobile regions).

3. Regions which started in the upper half of their country's distribution in the first period but moved down the distribution (downwardly mobile regions).

4. Regions which started in the upper half of their country's distribution in the first period and stayed there in the last period (permanently rich regions).

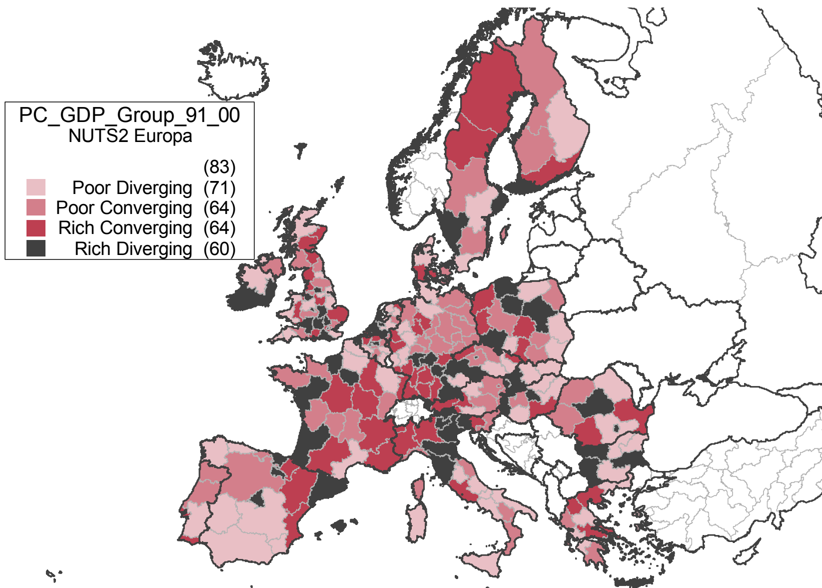
Finally, as a third measure of regional success or failure we follow the literature on extreme growth events (e.g. Hausmann et al., 2005, Berthelémy, 2006, Easterly, 2006, Aizenman and Spiegel, 2010) and focus on regions with rapid growth over a protracted period of time, a phenomenon we call a growth take-off. In particular for a region to experience such a growth take-off we require that it had growth levels of at least 2% per year for five consecutive years and that it outperformed the annual growth rate of the country average in each year of the period.[2]

Figures 2 to 5 and Table 1, page 34, display the geographic distribution of the different region types. Thus as can be seen from Figure 2, which considers the different convergence types for the two time periods considered. Out of the poor regions, i.e. regions with GDP levels below the country median, in 1991 around 47% were converging until 2000 and in the period from 2000 to 2009 this applied to 55%. The same applies productivity for which around 55% of the regions with levels of productivity below the country median in the initial years of 1991 and 2000 were converging in both periods. In the upper part of the distribution, by contrast, for GDP per capita 52% (in the 1991 to 2000 period) and 60% (in the 2000 to 2009 period), of the initially rich regions were converging. For productivity this applied to around 60% (in both periods) of the regions, respectively. Furthermore, for each variable considered, almost in every country and time period, poor and rich converging regions co-existed with poor and rich diverging regions.

Unconditional convergence as measured by this indicator is therefore not an automatic process taking place in all regions. Only about half of the initially poor and less than two-thirds of the initially rich regions converge over a 10 year period. Furthermore, convergence has low persistence and is often temporal in nature only. For both indicators only around half of the poor converging regions in the 1991 to 2000 period continued to converge in the later period and the same applied to slightly less than 50% of the rich converging regions in the 1991 to 2000 period. Similarly, in almost every country there is at least one region that converged in one decade but diverged in the other.

Figures 4 and 5 by contrast report the regional distribution of different mobility types in the countries analysed. The central stylized facts emerging from these figures are the low degree of mobility and the lacking persistence of mobility. Thus of the 135 regions starting in the lower

[2] The first criterion assures that regions are in a period of stable growth. The second criterion makes sure that this growth is not induced by national factors.



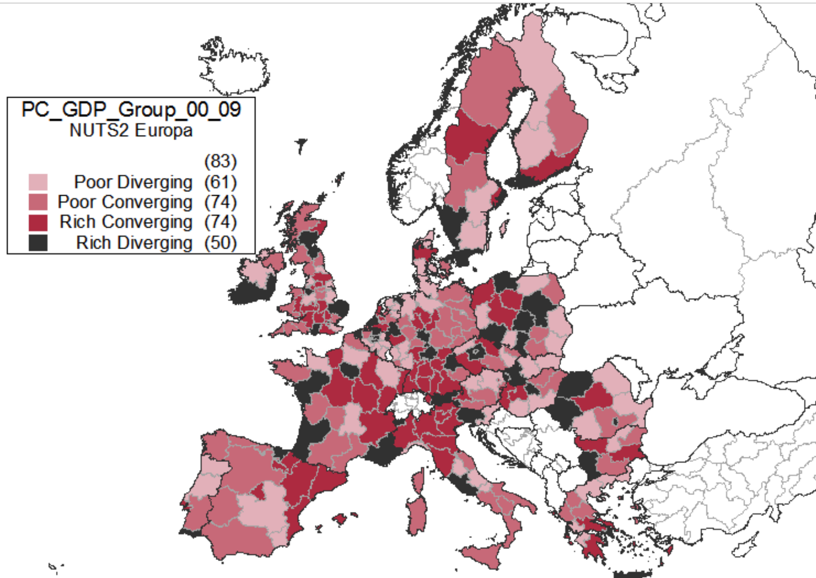




**Figure 2 Within-Country convergence/divergence in GDP per capita 1991–2000 and 2000–2009**

Source: Cambridge Econometrics, own calculations.

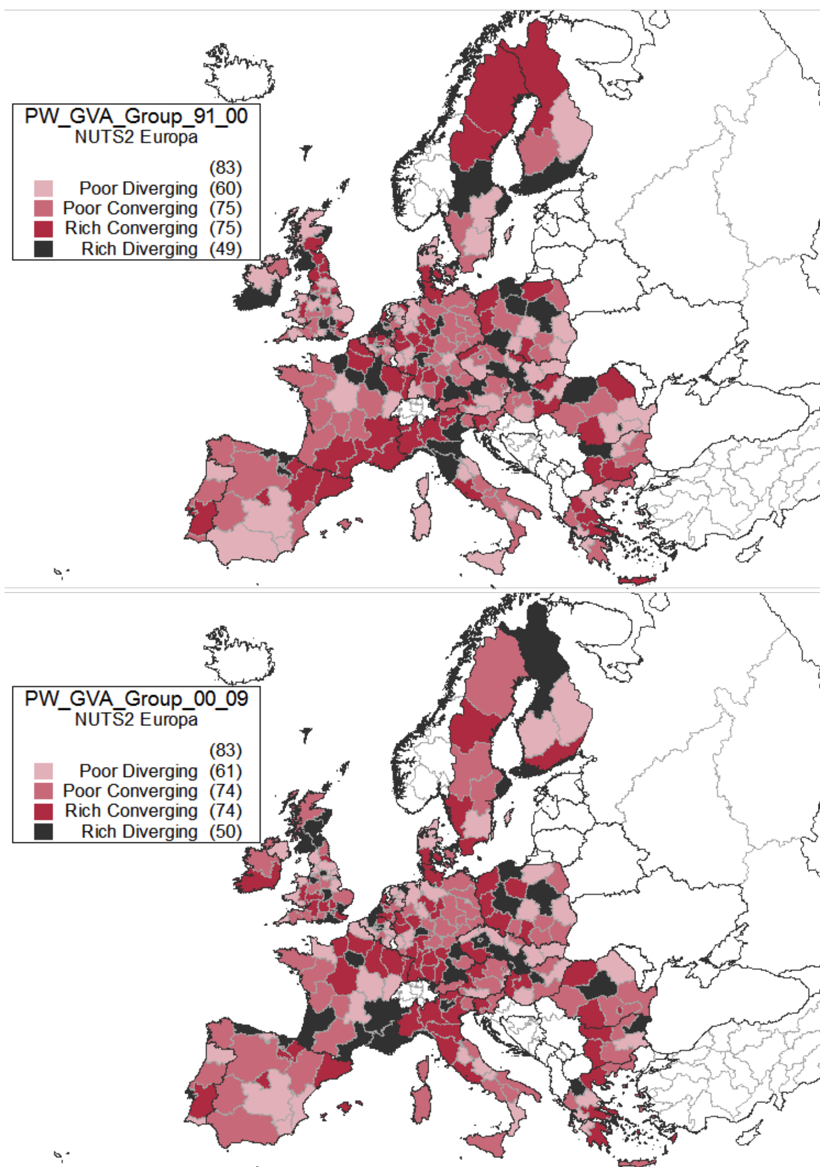



**Figure 3 Within-Country convergence/divergence in the productivity and wages 1991–2000 and 2000–2009**

Note: Productivity (= GVA per employed).

Source: Cambridge Econometrics, own calculations.

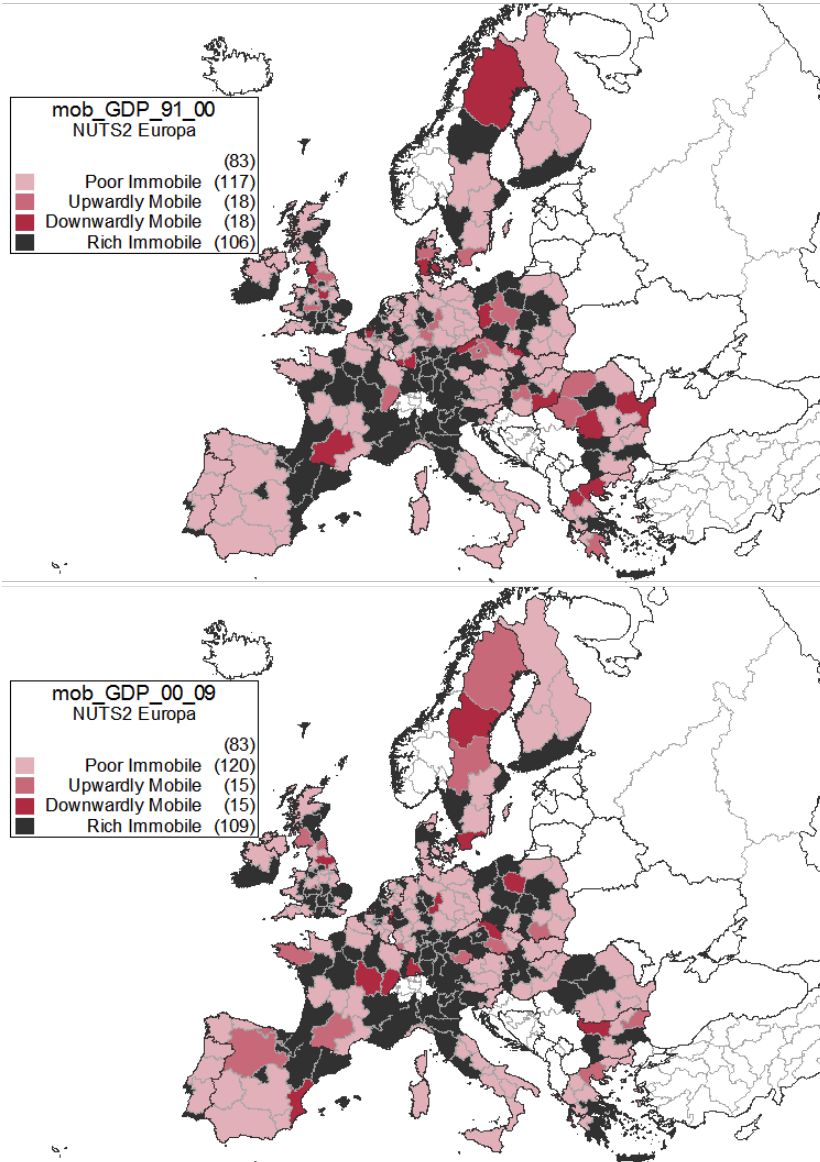



**Figure 4 Upward and downward mobility of regions in the GDP per capita distributions 1991–2000 and 2000–2009**

Source: Cambridge Econometrics, own calculations.

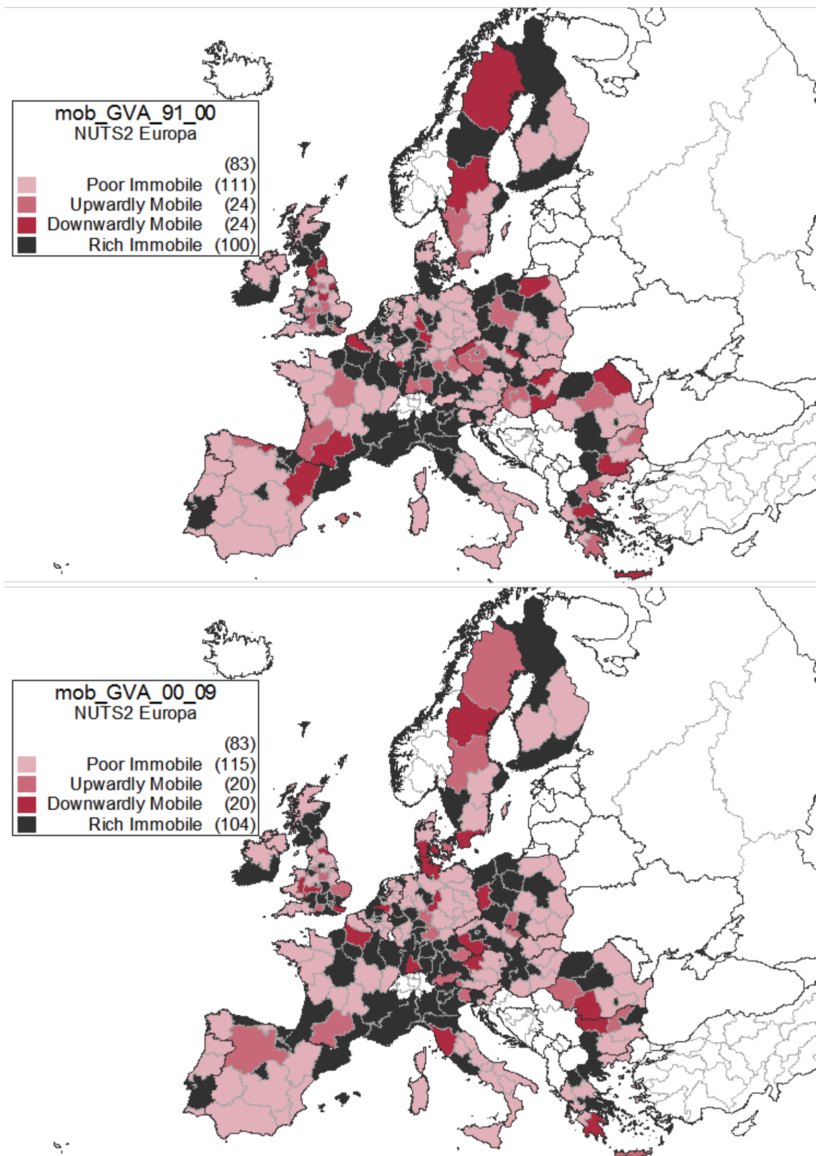



**Figure 5 Upward and downward mobility of regions in the productivity and wage distributions 1991–2000 and 2000–2009**

Note: Productivity (= GVA per employed).

Source: Cambridge Econometrics, own calculations.

| GDP per Capita | | | Productivity | | |
|---|---|---|---|---|---|
| **Regioncode** | **From** | **To** | **Regioncode** | **From** | **To** |
| BE31 | 1997 | 2002 | BE10 | 1991 | 1995 |
| BG41 | 2004 | 2008 | CZ01 | 1992 | 2002 |
| CZ01 | 1997 | 2003 | DE41 | 1997 | 2001 |
| DE41 | 1992 | 1996 | DED2 | 1999 | 2004 |
| DE80 | 1992 | 1996 | ES11 | 1995 | 1999 |
| DED1 | 1992 | 1999 | HU10 | 1993 | 1997 |
| DED2 | 1992 | 1996 | HU21 | 1993 | 1997 |
| DED3 | 1992 | 1996 | ITF5 | 1991 | 1996 |
| DEE0 | 1992 | 1997 | ITF6 | 1993 | 1997 |
| DEG0 | 1992 | 2001 | PL63 | 2002 | 2006 |
| ES11 | 2002 | 2006 | PT16 | 1992 | 1996 |
| ES13 | 1998 | 2002 | RO32 | 1992 | 1996 |
| ES30 | 1995 | 2000 | SE11 | 1996 | 2000 |
| ES41 | 2001 | 2006 | SK01 | 1991 | 1995 |
| ES61 | 2000 | 2006 | SK02 | 1991 | 1996 |
| ES63 | 2002 | 2006 | UKI1 | 2001 | 2007 |
| FI18 | 1994 | 1999 | | | |
| GR30 | 1998 | 2004 | | | |
| GR41 | 1994 | 1999 | | | |
| HU21 | 1993 | 1998 | | | |
| HU22 | 1995 | 1999 | | | |
| ITC3 | 1994 | 1998 | | | |
| PL12 | 1992 | 1999 | | | |
| PL34 | 1992 | 1997 | | | |
| PL41 | 1992 | 1998 | | | |
| PL51 | 1992 | 1996 | | | |
| SE33 | 2001 | 2006 | | | |
| SI01 | 1994 | 1998 | | | |
| SK01 | 1991 | 1995 | | | |
| SK02 | 1991 | 1996 | | | |
| UKH2 | 1996 | 2000 | | | |
| UKI1 | 1996 | 2003 | | | |
| UKM6 | 2002 | 2008 | | | |

**Table 1 Regions with a growth take-off**

Source: Cambridge Econometrics, OECD, Eurostat.

half of their country's GDP per capita level distribution in 1991 only 18 managed to cross the median GDP levels by 2000. In the period 2000 to 2009 again only 15 regions were upwardly mobile (and the same number was downwardly mobile). Furthermore of the 18 upwardly mobile regions between 1991 and 2000 in terms of GDP per capita, 7 fell back to levels below the national average in the following decade. Once more these stylized facts also apply to measures of productivity where in the 1991 to 2000 period only 24 regions (of which only 18 remained in the upper part of the distribution until 2009) were upwardly mobile, and in the 2000 to 2009 period this applied to only 20 regions.

Finally, Table 1 provides a summary of the time period in which regions experienced a growth take-off. These regions were mainly located in East Germany, and Central and Eastern Europe during the 1990s, and (in the north) of Spain during the early 2000s. What, however, sticks out once more is the low number of regions experiencing a growth take-off. In the 18 years of regional development considered in this chapter, we detected only 33 growth take-offs in GDP per capita growth. In terms of productivity growth such take-offs are even more seldom: Only 16 regions experienced a growth take-off in the last two decades.

## 1.3 Predictors of Successful Development of Lagging Regions

Our findings so far thus highlight the vast heterogeneity in growth and convergence experiences of regions relative to their respective country averages in the EU. From a policy perspective this suggests that protracted periods of catching-up and rapid growth are the exception rather the rule in most monetary unions. This thus sobers any hopes for a quick fix solution to the European periphery countries' competitiveness problems. From the analytical perspective, however, the natural question arises which factors (if any) can discriminate between successful and not so successful regions. Since our interest in this chapter is primarily on the process of poor regions catching-up, we focus on regions that initially had GDP per capita or productivity levels below the country median and use a series of probit regressions to analyse which variables are associated with a significant increase or decrease in the probability for successful catching-up in terms of GDP per capita and productivity using different definitions of successful regions. In detail we use three different indicators for successful regions. These are:

- First, set of two dependent variables that takes on a value of 0 if the region under consideration diverged from below and 1 if the region under consideration converged from below in terms of GDP per capita or productivity, respectively, in the time period considered.
- Second a further set of two indicator variables which takes on a value of 1 if the region was upwardly mobile and 0 if the region was permanently poor in terms of GDP per capita, or productivity, respectively, and
- Third, set of indicator variables which takes on a value of 1 if a particular region experienced a growth take-off in terms of GDP per capita or productivity in the period considered and 0 else.[3]

For the control variables we use a number of variables that are frequently used as explanatory variables in the regional growth literature (Durlauf et al., 2005, and Magrini, 2004, for surveys). These are initial values of the dependent variables (i.e. GDP per capita and productivity in the starting period), the investment intensity (i.e. total investments per capita), unit labour costs (measured as total real labour compensation in % of real GDP) all of which are taken from the Cambridge Econometrics data base, as well as the share of population with tertiary education[4] and the number of patents per million inhabitants, which were obtained from Eurostat sources. We also include variables capturing the sector composition of a region as measured by the share of employment in agriculture or industry, which was again taken from Cambridge Econometrics sources. All these variables are measured in logarithms relative to the country-wide average, to purge results from any country specific effects stemming from national institutions or policies. In addition, since regional development could be influenced not only by factors impacting on the own region but also on developments in nearby regions through spatial spillovers (see e.g. Ertur and Koch, 2007, LeSage and Fischer, 2008, Crespo-Cuaresma et al., 2012) we include two variables that take account of the spatial structure of the economy and capture potential spillover effects. These are a spatial lag[5] of the initial GDP per capita of neighbouring regions of the same country and a dummy variable that

[3] Note that in defining this variable – on account of the low number of successful regions – we have to give up our focus on catching-up and consider all 259 regions in the sample.

[4] For education levels data is only available from 1999 on, so that we use this earliest available observation.

[5] The spatial lag is based on a contiguity matrix $W$, with element $w_{ij} = 1/n$ if region $i$ borders on region $j$ and is located in the same country, and $w_{ij} = 0$ otherwise and with $n$ being the number of neighbors of region $i$.

takes on a value of 1 if the region under consideration does not border on regions of the same country (is an island) and is equal to 0 otherwise.

### 1.3.1 Predictors for Convergence from Below

A set of three different specifications is estimated for each of the two binary dependent variables indicating convergence from below in GDP per capita and productivity, respectively (Table 2). As can be seen from the results and in line with the beta-convergence literature (see Dobson et al., 2006, and Abreu et al., 2005, for recent meta-studies), we find that regions starting at a lower initial value ($Y$) of GDP per capita or productivity, have a higher probability to converge from below both in terms of GDP per capita and productivity. In addition the spatial lag of GDP, which was included to control for potential spillovers from neighbouring regions of the same country ($W * Y$), is insignificant for the probability to converge from below in terms of GDP per capita but significant for productivity. Islands have a significantly higher probability to converge from below in GDP per capita and the decade fixed effect *(1990s)* show that the chance for convergence from below in productivity was higher in the 1990s, while for GDP per capita no significant period effects can be found.

Besides these control variables that cannot be influenced by policy, variables associated with pro-active, growth oriented strategies are more strongly correlated with the probability of a backward region to converge from below than variables that can be associated with policies based on internal devaluation strategies. In particular the share of highly educated in the population *(TertEdu)* turns out to be the uniformly most significant and robust predictor of convergence from below in productivity and GDP per capita. Its impact is positive and highly significant across all specifications. Similarly, investments *(Invest),* are positively correlated with the convergence probability for GDP per capita and productivity, although the significance is not robust in all specifications. Unit labour costs, somewhat in contrast to prior expectations, on the other hand have a positive but insignificant correlation with the probability to converge from below. This therefore implies that higher unit labour costs are not associated with a decrease in the probability of poor regions to experience above average growth.

All other variables controlling for economic characteristics of the regions, by contrast, do not significantly contribute to predicting convergence.

| | (1) | (2) | (3) | (1) | (2) | (3) |
|---|---|---|---|---|---|---|
| | | GDP per capita | | | Productivity | |
| ***Y*** | −2.164*** | −2.729*** | −2.535*** | −4.504*** | −4.722*** | −4.981*** |
| | (−2.64) | (−3.49) | (−2.92) | (−3.99) | (−4.36) | (−4.06) |
| ***Invest*** | 1.020** | 0.759 | 1.121** | 0.794 | 0.651 | 0.940* |
| | (2.05) | (1.64) | (2.24) | (1.53) | (1.34) | (1.75) |
| ***ULC*** | 2.576 | 0.381 | 1.674 | 2.564 | 0.402 | 1.771 |
| | (1.63) | (0.26) | (0.99) | (1.50) | (0.25) | (0.95) |
| ***TertEdu*** | 1.374** | 1.525*** | 1.310** | 2.020*** | 2.027*** | 1.935*** |
| | (2.38) | (2.61) | (2.22) | (3.16) | (3.39) | (2.98) |
| ***W*Y*** | 0.204 | 0.0289 | 0.286 | 2.380** | 2.791** | 2.356* |
| | (0.26) | (0.04) | (0.35) | (2.00) | (2.47) | (1.94) |
| ***Island*** | 1.391** | 1.517** | 1.317** | 0.527 | 0.301 | 0.474 |
| | (2.50) | (2.57) | (2.34) | (1.30) | (0.69) | (1.18) |
| ***Patents*** | 0.0319 | | 0.0204 | 0.0594 | | 0.0530 |
| | (0.31) | | (0.19) | (0.55) | | (0.50) |
| ***p91_00*** | 0.103 | 0.0821 | 0.0985 | 0.438** | 0.325* | 0.431** |
| | (0.51) | (0.43) | (0.49) | (2.10) | (1.72) | (2.08) |
| ***IndShare*** | | 0.447 | | | 0.0818 | |
| | | (1.38) | | | (0.26) | |
| ***AggShare*** | | | −0.235 | | | −0.192 |
| | | | (−1.27) | | | (−1.01) |
| ***Constant*** | −0.0320 | −0.182 | −0.0467 | 0.0335 | −0.00155 | 0.0250 |
| | (−0.14) | (−0.82) | (−0.20) | (0.16) | (−0.01) | (0.11) |
| | −0.0320 | −0.182 | −0.0467 | | | |
| ***N*** | 226 | 236 | 226 | 228 | 237 | 228 |
| ***Pseudo $R^2$*** | 0.108 | 0.103 | 0.113 | 0.122 | 0.114 | 0.125 |

**Table 2 Pooled probit regression results for convergence**

Notes: Table reports coefficients of a probit regression on the probability of poor regions to grow with an above national average growth rate.

***, (**), [*] indicate significant coefficients at the 1%, (5%), [10%] level, respectively. Values in brackets are $t$-statistics of the estimates, based on heterosketasticity robust errors.

Source: Cambridge Econometrics, OECD, Eurostat.

Innovation measured by the number of patents per million inhabitants as well as measures of the sector structure of regions (the share of agricultural and industrial employment) turn out to be insignificant in predicting convergence from below for both dependent variables. On the one hand side therefore more innovation in peripheral regions does not necessarily increase the chances to grow above the national average – a fact that could potentially be explained by the lower absorptive capacity of these regions. On the other hand side the growth of these regions is also not impacted on by their sector structure – a fact that could be

interpreted as reflecting the varied comparative advantages of peripheral regions.

### 1.3.2 Predictors for Upward Mobility

Similar stylized facts also apply to the regressions for upward mobility. Although in this specification – on account of the few successful regions, – the low variance of the dependent variable leads to lower significance levels, again tertiary education as well as investments are significantly positively correlated with upward mobility in productivity, although the later is only weakly so. For GDP per capita, by contrast, the number of patents is weakly significantly positively related to upward mobility. Unit labour costs once more although having the expected negative sign, are statistically insignificant in all specifications for both variables.

The signs of control variables, however, differ somewhat between the specifications for upward mobility and convergence from below. The initial value of GDP per capita and productivity is highly significantly negative in all specifications. This, however, is no big surprise given that the initial value relative to the country average reflects the distance to the median country level. The positive coefficients therefore reflect the fact that the higher the initial level of GDP per capita or labour productivity, the shorter the distance to the country average, and thus the higher the probability for upward mobility. Spillovers from neighboring regions ($W * Y$) have an insignificant negative correlation with upward mobility in terms of GDP per capita, but a positive one with the probability to be upwardly mobile in terms of productivity. This implies that for GDP per capita vicinity to rich regions reduces the probability of upward mobility for poor regions – a fact that could be due to withdrawal effects – while being close to high productivity regions increases the probability of upward mobility in productivity, due to positive spillover effects. Also in contrast to results for convergence from below the dummy for the 1990s remains less significant for productivity and islands have a less significant effect on the probability for upward mobility in GDP per capita than on the probability for convergence of poor regions.

Unlike for convergence, sector structure is more important for upward mobility: The share of industrial employment *(IndShare)* is significantly positively correlated with upward mobility of a region in terms of GDP per capita as well as productivity and the share of agricultural employment *(AgriShare)* is negatively, although insignificantly, correlated with upward mobility of a region in the productivity distribution.

| | (1) | (2) | (3) | (1) | (2) | (3) |
|---|---|---|---|---|---|---|
| | | GDP per capita | | | Productivity | |
| ***Y*** | 6.123*** | 6.291*** | 6.188*** | 5.984*** | 5.674*** | 5.149** |
| | (3.91) | (3.85) | (3.76) | (3.05) | (2.78) | (2.57) |
| ***Invest*** | −0.496 | −0.534 | −0.515 | 0.991 | 1.124* | 1.267* |
| | (−0.64) | (−0.67) | (−0.66) | (1.46) | (1.67) | (1.80) |
| ***ULC*** | −1.017 | −2.740 | −0.911 | −0.596 | −2.992 | −1.774 |
| | (−0.52) | (−1.43) | (−0.45) | (−0.26) | (−1.47) | (−0.72) |
| ***TertEdu*** | 0.430 | 0.836 | 0.443 | 2.142*** | 2.577*** | 1.990** |
| | (0.56) | (0.96) | (0.56) | (2.87) | (3.35) | (2.55) |
| ***W*Y*** | −0.803 | −1.154 | −0.831 | 1.650 | 2.007 | 1.603 |
| | (−0.70) | (−1.02) | (−0.73) | (1.04) | (1.31) | (0.96) |
| ***Island*** | 0.896 | 1.266* | 0.901 | 0.232 | 0.736 | 0.177 |
| | (1.42) | (1.77) | (1.41) | (0.45) | (1.24) | (0.35) |
| ***Patents*** | 0.256* | | 0.256* | 0.0946 | | 0.104 |
| | (1.70) | | (1.70) | (0.71) | | (0.77) |
| ***p91_00*** | −0.223 | −0.0232 | −0.221 | 0.390 | 0.448* | 0.374 |
| | (−0.77) | (−0.08) | (−0.77) | (1.53) | (1.88) | (1.45) |
| ***IndShare*** | | 0.998** | | | 1.061*** | |
| | | (2.20) | | | (3.18) | |
| ***AggShare*** | | | 0.0343 | | | −0.354 |
| | | | (0.13) | | | (−1.60) |
| ***Constant*** | 0.0417 | −0.125 | 0.0436 | 0.137 | 0.0919 | 0.122 |
| | (0.13) | (−0.40) | (0.14) | (0.47) | (0.33) | (0.42) |
| | | | | 0.137 | 0.0919 | 0.122 |
| ***N*** | 226 | 236 | 226 | 228 | 237 | 228 |
| ***Pseudo $R^2$*** | 0.182 | 0.184 | 0.182 | 0.196 | 0.221 | 0.208 |

**Table 3 Pooled probit regression results for upward mobility in GDP per capita and productivity**

Notes: Table reports coefficients of a probit regression on the probability of poor regions to move to a position in the upper half of the national distribution.
**, (**), [*] indicate significant coefficients at the 1%, (5%), [10%] level, respectively. Values in brackets are $t$-statistics of the estimates, based on heterosketasticity robust errors.

Source: Cambridge Econometrics, OECD, Eurostat.

### 1.3.3 Predictors for Growth Take-offs

Finally, in predicting growth take-offs we have to follow a slightly different econometric approach than for upward mobility and convergence from above. The reason for this is that such a growth take-off can occur at any point in time. This implies that the appropriate model for estimating the probability of a take-off is a random effects panel probit model, in which, however, the effects of neighbouring regions cannot be identified on account of the low time variance in this variable. In Table 4

| | (1) | (2) | (3) | (1) | (2) | (3) |
|---|---|---|---|---|---|---|
| | | GDP per capita | | | Productivity | |
| ***Y*** | −5.351*** | −4.975*** | −7.598*** | −3.849*** | −2.680 | −5.113*** |
| | (−5.43) | (−5.49) | (−6.76) | (−2.95) | (−1.62) | (−3.75) |
| ***Invest*** | 1.445** | 0.660 | 1.706** | 0.422 | 0.221 | 0.862 |
| | (2.06) | (1.03) | (2.34) | (0.42) | (0.27) | (0.83) |
| ***ULC*** | 2.730 | 0.164 | −1.124 | −2.578 | −4.201 | −5.184 |
| | (1.15) | (0.08) | (−0.44) | (−0.72) | (−1.36) | (−1.43) |
| ***TertEdu*** | 1.593* | 1.675** | 1.032 | 3.135** | 3.077** | 1.997 |
| | (1.92) | (2.21) | (1.23) | (2.50) | (2.45) | (1.53) |
| ***Patents*** | 0.278* | | 0.210 | 0.717** | | 0.643** |
| | (1.74) | | (1.26) | (2.49) | | (2.17) |
| ***IndShare*** | | −1.098*** | | | −0.627 | |
| | | (−2.69) | | | (−0.91) | |
| ***AggShare*** | | | −1.379*** | | | −1.122*** |
| | | | (−4.88) | | | (−3.16) |
| ***Constant*** | −4.857*** | −5.052*** | −5.637*** | −5.537*** | −4.298** | −5.977*** |
| | (−14.03) | (−15.75) | (−15.83) | (−9.78) | (−2.01) | (−9.13) |
| ***N*** | 3008 | 3049 | 3008 | 3069 | 3112 | 3069 |
| ***rho*** | 0.834 | 0.850 | 0.860 | 0.685 | 0.834 | 0.696 |

**Table 4 Panel probit regression results for take-offs in GDP per capita and productivity**

Notes: Table reports coefficients of a panel probit regression on the probability of regions to experience a takeoff.
**, (**), [*] indicate significant coefficients at the 1%, (5%), [10%] level, respectively. Values in brackets are $t$-statistics of the estimates, based on heterosketasticity robust errors.

Source: Cambridge Econometrics, OECD, Eurostat.

we therefore report the results of such a model – excluding neighbouring region impacts.

In accordance with previous results – a significantly positive impact on the probability to experience a growth takeoff in terms of both productivity as well as GDP per capita arises from the share of highly educated population and the investment intensity. By contrast unit labour costs once more have an insignificant impact on the probability to experience a growth takeoff both in terms of productivity and GDP per capita growth and the share of agricultural employment in the region has a significantly negative impact on the probability of experiencing a growth takeoff in both GDP per capita and productivity growth.

In contrast to previous results, however, in this specification also the number of patents per million inhabitants is significantly positively correlated with the probability to experience a growth take off, in all spec-

ifications for productivity and in one specification where for GDP per capita. Also, unlike for the previous specifications, the share of industrial employment has a significantly negative impact on the probability to experience a growth takeoff both in terms of GDP per capita as well as in terms of productivity. The reason for this difference in results may, however, be that – in contrast to the previous regressions – when considering growth takeoffs, we also include rich regions in the analysis, which may be expected to have different comparative advantages than poor regions when considering sector specialization and also higher absorptive capacities in terms of patents per million inhabitants.

## 1.4 Conclusions and Discussion

In sum our evidence therefore suggests that in existing currency unions successful restructuring of regions with the aim of regaining competitiveness is usually associated with pro-active, growth oriented policies. In particular our results highlight the important role of a highly skilled workforce and productive investments for successful catching-up both in terms of productivity and GDP per capita. By contrast, we find very little evidence of a close correlation between internal devaluation and catching-up.

Drawing on the analogy from regions within countries which, as argued in the introduction, are by definition geographic entities in a currency union, to countries in the EMU, that share the impossibility for external devaluation with regions in a country, we would therefore argue, that current strategies aimed at re-establishing the competitiveness of the countries of Europe's Southern periphery, should be augmented by more pro-active, growth oriented strategy elements focussed on triggering investments and attracting a highly qualified workforce.

Such a strategy will have to be developed by the peripheral countries themselves and will need to be based on the specific comparative advantages of each of the countries. To implement such a strategy therefore the periphery countries need to develop a vision of where they want to be in terms of economic development after successful consolidation. Even if the financial means available for such an active strategy are limited, this vision is needed to guide the structure of expenditure and investment as well as of budget cuts and to point out the impediments to structural change that have to be abolished. Irrespective of its concrete content also this vision should be developed in and by the country itself, be

elaborated jointly with experts, be based on a broad national consensus on the priorities of future governments and will need to be broadly communicated to the public. Furthermore, the concrete policy measures following from the vision will have to be coordinated with the necessary measures to reduce budget deficits so as to achieve higher growth without renouncing budgetary discipline. This would necessitate a shift in the structure of expenditures to more future oriented expenditure categories (such as education, investment and innovation) and away from administration, high pensions for specific groups and the military, as well as shifts in the structure of taxation from taxing labour to taxes on property or on financial transactions and increasing tax revenues through improved compliance of taxpayers.

Our results also suggest that such a strategy should put a strong priority on triggering investments and improving educational attainment levels of the workforce. Furthermore, the low productivity growth rates of the periphery countries in the last decade suggest that restarting productivity growth is key to successful reform. Thus strategies to foster private investments, FDI, more innovation and better cooperation between firms as well as better schools and universities will have to be designed and national education systems will have to be scrutinized as to whether they provide adequate skills to the population.

This could be achieved by many different individual measures. For instance industrial policy could be re-oriented on promoting entry of new firms and competition as well as attracting FDI's to accelerate technology transfers and boost productivity and increasing exports specifically to fast growing global markets rather than subsidizing large firms and preventing the market exit of already unviable enterprises. Furthermore, given the comparative advantages of all periphery countries in tourism, strategies aiming to upgrade the currently low value added mass tourism to more highly value added forms (such as health and wellness tourism or cultural tourism), and to lengthen seasons (e.g. by diversifying visitor structures and attracting new customers from non-EU countries) could be an important element in such a strategy. Finally the southern countries – given their history and location – are natural bases for trade with the Mediterranean region and South America. This could be used to boost exports and to develop these countries into an export hub to the fast growing markets of this region.

Similarly, reforms directed at the education system should take care to more closely orient education to labour market needs and to also provide

for adequate medium level and vocational and technical skills training, while reforms directed at the university level will have to aim at fostering the cooperation between universities and enterprises (e.g. through spinoffs, cooperation with SMEs or research contracts with manufacturing firms).

While the peripheral countries themselves are therefore clearly the most important actors in designing their reform packages, our theoretical considerations also suggest that these national endeavours will need the to be supported and monitored by the higher tier government levels (i.e. the European Commission) and have to receive economic support of the centre of the EU (i.e. countries such as Germany and Austria). Here the European Commission, aside from taking the role of a monitoring institution, which it has already assumed, should – in the light of the limited financial resources of these countries and in order provide a counterbalance to this rather unpopular role – also aim to assume the role of the "financier of the future" for the peripheral countries: Additional financial resources from the EU-budget as well as from the EIB should be targeted to the periphery countries, reform contracts with additional financial incentives could be provided to the governments of the periphery countries (and should be described as a welcome source of additional finance for the future projects of the respective governments, rather than as a further imposition of German austerity measures) and existing financial resources should be used more efficiently by better co-ordinating between individual EU-funds as well as by more effective monitoring and evaluation.

In the long run, however, it is highly unlikely that such ad-hoc measures will suffice to cushion the substantial asymmetries within EMU. A fiscal transfer system that acts as an automatic stabilizer for regions affected by asymmetric shocks must therefore be part of the governance structure of EMU. Such a transfer regime could be based on a common European unemployment insurance system or other social transfers on the expenditure side of the EUs budget, or on business cycle sensitive taxes such as financial transaction taxes on the revenue side. Finally, the European Commission will also need to continue to encourage inter-governmental support and knowledge transfer, when it comes to designing labour market, industrial and also regional policies.

The task of the countries in the centre in such a policy initiative, by contrast, would be to facilitate positive spill-overs to facilitate adjustment in the periphery. This could on the one hand side be achieved through a

more expansionary policy stance that allows wages to grow at least at the pace of productivity, reduces income disparities within countries and by stimulating private enterprises that are currently net creditors. On the other hand side, these countries could also increase demand by fostering investments with double dividends (like investment into environmental and energy saving technologies) and pursuing the goals of Europe 2020.

In sum therefore successful reform strategies in the European periphery countries will need pro-active, growth oriented policies that are "owned" by the countries themselves, that are, however, supported and closely coordinated with both higher tier levels of government and the countries of the centre. Even at their best, however, judging from our evidence, these policies are unlikely to yield immediate success and restructuring the Southern European periphery is likely to preoccupy policy makers in Europe for quite some time.

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# 2 Eurozone: Crisis, Stabilization, Solution?

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## 2.1 Introduction

Eurozone (and implicitly the whole EU) finds itself at the crossroad. Economic dynamism of the last few years revealed fissures in the European economic and increasingly political edifice. The vaunted achievement – the common currency euro – proved itself to be the double-edged sword. The common currency certainly contributed to the increased integration both in the real and the financial sectors. However, in the presence of the persistent differences between the “northern core” and the countries on the Mediterranean littoral, this enhanced integration acts more as an undesirable weight and obstacle rather than the dreamed about engine of progress.

Because the costs of “un-integration” are perceived to be prohibitive, the EU – and especially the Eurozone – are forced to seek common, cooperative solutions. In practical terms, the alternative to the Eurozone’s restructuring and (at least partial) return to national currencies is seen in steps toward the increased “fiscal” integration (fiscal union) and the “banking union”. However, the recently intensified discussion indicates the lack of a common understanding of these concepts. Several different variants of each are advanced, which is certainly not instrumental in reaching the consensus required for practical steps.

However, the one thing appears to be obvious. Whatever the form of the fiscal and banking union(s), the transfer of resources is implicit (and seemingly necessary) for those unions if they are to provide the underpinnings for the current structure of the monetary union. This indeed raises the question of the governance of these unions – both fiscal and monetary. After all, the provision of resources implies an allocation – and it is hard to imagine that resources will be provided to the common pool (i.e. to the fiscal and banking union) unless the provider has some say with respect to the allocation of those resources. And that requires some

form of common (i.e. centralized) decision making procedures, in all likelihood exceeding the common understanding of Acquis communautaire as it exists today – i.e. some form of the effective political union.

Given the significant political content in deciding about taxes, expenditures and resource transfers (i.e. the fiscal and banking unions), some mechanism of the political governance involving the democratic processes appears to be necessary for these unions. That then requires the discussion of the following interrelated questions:

a) Is the current “rescue architecture” sufficient to stabilize the Eurozone both in the short and the long-terms?

b) What kind of arrangements is feasible for the stable Eurozone in the long run?

If the acceptable answer to these questions cannot be found, the future of the European experiment is, indeed, “in doubt”.

## 2.2 How Did We Get Here

### 2.2.1 Agreements and Institutions

Many analysts today consider the root of the European crisis to be the existence of the common currency without the corresponding common European institutions in the areas of the fiscal policy and the financial markets (especially, but not exclusively, the banking sector). And, indeed, if both the fiscal and financial policies would be significantly centralized, some kind of the political mechanism capable of overriding individual national decision-making processes is necessary. Such a conclusion appears to be “obvious” today – but how did we get to the current structure?

The idea of the common European currency was the integral part of the Maastricht Treaty which established the European Union in December 1992. The expectations at the time were that the time needed to move from the idea to the reality of the common currency (7 years) will be utilized to reach a consensus and to create the “European” institutional structure which would support the stability of the envisaged new common currency and facilitate the new age of the “transnational” Europe.

To support the fiscal discipline and stability of the "new" currency, the signatories of the Maastricht Treaty who committed themselves to the common currency (Germany, Netherlands, Belgium, Luxembourg, Ireland, France, Spain, Portugal, Greece, Italy) plus the three new members who joined the EU under the Maastricht conditions in 1996 (Austria, Finland, Sweden) signed and ratified the Stability and Growth Pact (SGP) in 1997. SGP specified limits for public finances fiscal deficits and formulated procedures and penalties for a non-compliance. Finally, the Financial Services Action Plan (FSAP), first formulated in 1999, mapped the road for the financial sector evolution under the new common currency regime. However, the responsibility for the financial sector stability (supervision, deposit insurance and the resolution of "problems") remained in jurisdictions of the individual member states.

The political integration processes and the EU governance were further elaborated by treaties of Amsterdam (1997) and Nice (2001). These, in their respective areas further specified – and somewhat modified – the Treaty of Maastricht. Finally, in 2001 the process was launched to replace the set of the intergovernmental treaties as the building blocks of the EU by the one all encompassing document, termed the "European Constitution". It was envisaged that the European Constitution will create a base for the genuinely transnational, "European" decision making processes and governance. The relevant document was signed by the all member and candidate countries in 2004. It was expected that this new governance structure will pave the way for the development of the "European" – i.e. the transnational – fiscal and financial institutions, which, together with the further progress in the creation of the single market will lead the way toward a genuinely "European" economy, where the common currency will be completed by the common fiscal and financial structures.

However, the "European Constitution" was rejected in the French and Dutch referenda in the Spring of 2005. To replace it, the EU members agreed to the so called Lisbon Treaty, which was ratified by the all and came into force in December of 2009.

Even if the Lisbon Treaty incorporates many governance and structural elements of the rejected "constitution", two important characteristics should be stressed. First is that the "treaty" reaffirms (albeit implicitly) the nature of the EU as the intergovernmental arrangement – meaning that the ultimate sovereignty and legitimacy remains with the individual member states governments. EU level rights and responsibilities are de-

fined (Acquis communautaire), but limited. And the second is that any changes to the existing structure of rights, obligations and responsibilities within the EU – i.e. the changes to the overall governance structure – can be done only in the form of treaty changes, which then must be ratified by the all participatory entities (i.e. the member states).

Many analysts and commentators consider this state of affairs insufficient (if not dysfunctional) as far as the economic policies are concerned, especially with respect to the desirable functioning of the monetary union. However, it must be stressed that the existing arrangements are the results of the hard negotiated political compromises. And these, indeed, reflect the multifaceted diversity of EU and especially the Eurozone member states.

Under these circumstances, the questions about the functionality (and, indeed, the survivability) of the monetary union can and should be asked. To answer these questions, a look at the actual economic and political dynamics of the Eurozone is necessary.

### 2.2.2 Economy

In the first 10 years of its existence, the common European currency (euro) appeared to be highly successful (DG ECOFIN, 2008). Indeed, the problems existed but were considered to be either insignificant or solvable. Most visible at the time were the divergences in competitiveness (as measured by the unit labor costs based real effective exchange rates – REERs) between the countries on the Mediterranean littoral and the rest, especially Germany.

However, these were usually explained by pointing out that the Germany entered the Eurozone with the overvalued exchange rate, hence the observed divergencies were actually equilibriating processes. This explanation (false, as it turned out) was sometimes supplemented by pointing out at the possibility (and desirability) of the Ballasa–Samuelson phenomenon to be expected in the economically less advanced Mediterranean counties, together with possible statistical biases as a consequence of the structural changes associated with the advancing globalization processes. (For the more detailed discussion, see Rusek, 2012.)

The fastly diverging current account positions (growing deficits of countries on the Mediterranean littoral and growing surpluses especially in Germany) were attributed to the "catching up" processes and (to a lesser

degree) to the observed German economic malaise (Sinn, 2007). At any case, the prevailing theory maintained that current account positions play no role within the currency union. Similarly, the persistent inflationary differentials – especially between the Mediterranean countries and Germany – were attributed to both the catching up processes and the structural inertia. Basically nothing to be concerned about as long as the overall inflation in the Eurozone remained close to the ECB target of 2% (even if this target was more often than not exceeded, causing some uneasiness).

On the other side, the expansion (the "Europanization") of the large European banks outside their home countries, together with the development of the Eurozone-wide government and commercial bonds market and the continuous reduction in the "home bias" of financial asset holders were hailed as the common currency successes. In the opinion of many, these developments heralded the arrival of the euro on the international scene as the equal (and perhaps, in the not so distant future, the successor) of the US dollar.

There were, indeed, the matters of concern. The sluggishness of the German economy (till 2006) was the major one. So was an increased international competition on some markets (sometimes referred to as the "impact of globalization"). It was felt that the "underperformance" of the major EU economy combined with the need to stay competitive with emerging markets may pose a threat (even if undefined) to the cherished "European" economic and social model. Finally, the SGP appeared to be under some pressure.

When the "problems" were recognized the effort was made to find remedies within the confines of the common currency. The German reforms of the labor markets and (to a degree) the welfare state (known as the Hartz IV and enacted in 2004) were successful. German economy re-acquired it dynamism (in the European scale and context) in 2006, mostly via an increased flexibility and global competitiveness. The globalization impact was to be addressed by adopting the so called Lisbon Agenda (March 2000 – please do not confuse with the Lisbon Treaty of 2009). This agenda aimed at "making the EU the most competitive and dynamic knowledge-driven economy by 2010". (Euractiv, 2004) Finally, the SGP was revised (practically, watered down) in 2005.

Nevertheless, one has to distinguish between the "problems being addressed" and the "problems being solved". Whereas the German Hartz IV reforms were undoubtedly successful for Germany, the Lisbon Agenda

failed and with the onset of the ongoing crisis was for all practical purposes abandoned. Revised SGP was the subject of controversy from its inception, but it mitigated tensions and incipient conflicts.

Given the above outlined dynamics – including its political and institutional elements – how did it happen that the Euro, successful in its first 11 years, is today often doubted and many analysts question its survival in its current form? To answer this question, let us look at the actual interplay of economic dynamics, institutions and politics during the first decade of the Euro's existence.

### 2.2.3 Economic Dynamics

Euro as a common currency was successfully introduced by eleven participating countries (Germany, Netherlands, Belgium, Luxembourg, Ireland, France, Spain, Portugal, Italy, Austria, Finland) in January 1999. Greece then joined in 2002. (Other countries – Malta, Greek Cyprus, Slovenia, Slovakia, Estonia – joined between 2007 and 2011. But these are very small and their economies are inconsequential as far as the subject under discussion here is concerned.)

On the technical side, the euro is managed by the European Central Bank (ECB). This institution is independent of the participating countries and its primary mandate is to maintain the price stability, defined as the Eurozone inflation not exceeding 2% annually. In its task the ECB is supported by the institutional arrangements described above. Moreover, it should be obvious that the reasonably free trade and the unrestricted capital flows are the sine qua non of the common currency (referred to subsequently as the Eurozone).

The first effect of the common currency was the convergence of the nominal interest rates. This result is understandable as long as markets consider the Eurozone an area where risks between different asset issuers (member countries) are very similar. Arbitrage then imposes a uniform return on the assets of the same currency denomination and (perceived) very similar risk properties.

Inflation remained close (but often above) the ECB's target rate. However, within this overall number the persistent differences between the North and the Mediterranean littoral remained. This phenomenon requires more research, however one may surmise that the goods arbitrage remained imperfect in the spatially separated markets, supporting the

price setting inertia (a tradition of higher inflation) in the South (the Mediterranean littoral countries).

The combination of those two phenomena resulted in the diverging real interest rates – the Southern (Mediterranean) ones being significantly less than the Northern ones. This, indeed, increased the "Southern" demand for credit, accelerating the economic growth and hence increasing the tax receipts. Spain and Ireland run large budget surpluses, reducing significantly their debt to GDP ratios. Italy achieved a primary surplus. After violating SGP criteria at the beginning of the 2000's, Portugal achieved a budgetary stability. Only Greece remained a significant public finance problem, but it was not known at the time (even if suspicions existed).

The increase in credit was financed by the domestic banks which in turn obtained resources on the interbank markets – i.e. basically by tapping the "Northern" savings. Statistically, this phenomenon appeared as the capital inflow – i.e. the current account deficits.

However, this dynamics had important effects which remained unnoticed (or noticed but ignored) at the time. Most of the capital inflow financed the increase in consumption, especially in housing and related consumer durables. Given the generally lower consumption and the lower quality of the housing stock of the "Southern" countries, this kind of behavior may be sociologically and psychologically understandable, nevertheless… Capital inflows maintained the domestic demand, a significant part of which fell on the non-tradeables sector. Combined with the labor markets rigidities, this tended to increase both employment and wages. However, the growth was mostly in the low productivity sectors (construction and services). Hence the unit labor costs (ULC) increased and the REERs based on ULC tended to appreciate. Simultaneously the Hartz IV reforms in Germany led to the (statistically observed) wage restraint and increases in productivity – i.e. the German ULC based REER tended to depreciate. These two phenomena led to the increase of the competitiveness gap between the "North" and "South". Moreover, the capital inflow induced demand (and wage and credit) expansion in the South tended to perpetuate the inflation and hence the real interest rate differentials. This prolonged the just described processes and led to increased "North-South" divergencies.

Additionally, this pattern of lending increased the risks for the banks balance sheets – the phenomenon ignored by the national regulators. (One may surmise, however, that it would be ignored (or misunderstood?) by

a hypothetical Eurozone-wide regulator as well. After all, the similar phenomenon was ignored by US regulators at the same period.) The problem here is that if a substantial part of bank assets (lending) is in the consumption – i.e. the individual income – related loans, then any shock to the individuals income generating power affects the loan servicing abilities, i.e. the riskiness of lending institutions balance sheets. And indeed, if the lending bank resources depend on the interbank markets, the rising riskiness reverberates throughout the banking system.

Finally, one should mention here that the so called "Greek Problem" existed, with both phenomena mentioned above present. However, the trigger of the "Greek crisis" – the extensive public sector deficits far in excess of even the modified SGP rules – were hidden in the biased Greek data reporting, officially unknown till 2009.

To summarize at this point, in the first 10 years of its existence the Eurozone outwardly appeared to be successful, but as the above analysis indicates it was becoming increasingly fragile – even if this fact was unknown (or was ignored) at the time. The question indeed should be asked whether different institutional and governance structures could make the Eurozone more resilient in the face of the shocks observed from 2009 onwards.

The answer is necessarily speculative. One may surmise that a closer supervision and a coordination of fiscal policies, combined with a better statistical reporting (even along the lines of the recently agreed treaties) could identify Greek problems much sooner and make the necessary remedies less costly both financially and in (Greek) human terms. It is useful here to stress that except Greece all other countries complied with the SGP fiscal restrictions as late as 2008.

As far as the elements of the "financial union" are concerned, it is unlikely that the rising fragility of the banks balance sheet would be detected by an Eurozone-wide bank supervisor any better than national authorities. Similarly, the introduction of the Eurozone-wide deposit insurance fund might actually encourage more risky lending practices, making the banking sector yet more vulnerable ex-post.

Finally, one always has to keep in mind that the EU (and, by implication, the Eurozone) is the organization of the legally independent nation-states. Its legitimacy is derived from the democratic legitimacy of the individual national governments. And that indeed places a limit on policies and arrangements which would imply the transfer of both resources and decision-making powers ex ante.

### 2.2.4 The Onset of the Crisis

Some authors place the beginning of the European (and world) financial crisis at August 9, 2007, when BNP Paribas announced losses on sub-prime mortgages and the Dow crashed 387 points (Canuto, 2012). The real economy reacted with some delay and measured by the GDP dynamics, the European recession commenced only in 1Q 2009. Indeed, the fall 2008 saw banking dramas in the Iceland and Ireland. However, many people connected those events with the US financial instability associated with the Lehman Brothers collapse and AIG bail-out. In reality both were the result of faulty business models combined with the lack of the proper supervision, especially as far as the international operations of the Irish and Icelandic banks were concerned.

The real beginning of the European crisis is November 2009, when the newly elected Greek prime minister Papandreu revealed that the actual Greek public deficit and debt are significantly larger than previously reported. Subsequently announced "austerity" measures triggered intensive protests in Greece but were deemed inadequate by the financial markets. Interest rates on the Greek debt increased significantly and by April 2010 Greece was locked out of the access to credit. To fend off the threat of Greek bankruptcy – and hence the exit from the common currency – the first "bail-out" program was agreed upon. 110 billion euro were to be provided over 3 years in exchange for the additional budgetary restraints and the regular outside control of the fiscal stabilization program by so called "Troika" (EU, ECB, IMF).

To handle possible future problems, EU established the European Financial Stability Facility (ESFS) – basically a limited rescue fund, endowed with 440 billion euro and scheduled to complete its operations by the mid 2013. (The restrictions were necessary so that the bail-out mechanism – that is what ESFS essentially is – could be created, even if its existence at the time was incompatible with the existing EU treaties. ESFS was expected to provide a short-term, basically "bridge" financing to countries limited in their ability to access financial markets. Such loans entailed strict budgetary conditionalities (often referred to as "austerity requirements" in public discourse jargon). It is useful to point out that the above mentioned 110 billion euro for Greece was not the part of ESFS.) It was hoped that the EFSF will serve as a combination of the deterrent and insurance, inducing the financial markets to provide the financing to "more crisis affected" countries at reasonable terms and

at the same time inducing the countries to stabilize their fiscal positions (in a sense a "voluntary" austerity).

Nevertheless, the difficulties did not stop with Greece. Ireland asked for (and was granted) the ESFS financed bail-out in November 2010 and Portugal in May 2011. In June 2011 it became obvious that the initial Greek bail-out program was insufficient and the second, more strictly conditional bail-out program for the country was approved in July 2011, this time as the part of ESFS. (Simultaneously, the remaining funds from the first Greek bail-out were rolled into the ESFS as well.)

However, the ESFS remained on a rather shaky legal ground. Moreover, it was becoming obvious that the economic and financial situation is not improving. This constituted an implicit threat to the stability of not only the bail-out countries, but to the cohesion and stability of the whole Eurozone.

Hence, the EU decided to establish the European Stability Mechanism (ESM). ESM is intended to be a large permanent fund intended to provide a conditional financial assistance to the Eurozone member countries in difficulties. To overcome the legal ambiguity of ESFS, the ESM was established as an amendment to the Lisbon treaty, currently the ruling EU document. Formally, the ESM became operational October 8$^{\text{th}}$, 2012.

Simultaneously with the steps designed to alleviate (albeit unsuccessfully) the emerging fiscal crisis in some Eurozone countries, EU (and the Eurozone) resolved to adopt measures which would prevent (or at least mitigate) the re-emergence of the fiscal crises in the future.

The most important among those steps is the adoption of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG), commonly called Fiscal Stability Treaty. Ratified in October 2012, the TSCG became the integral part of the EU legal system (even if it is formally specified as "intergovernmental treaty", not the "EU law"). For details and precise formulations, see TSCG (2012).

Simultaneously, the EU commission adopted the so called "six-pack" – the set of five regulations and one directive (hence "six-pack") aimed at the strengthening of the fiscal discipline (including the budgetary and debt limits and disciplining corrective measures) and preventing and correcting macroeconomic and competitiveness imbalances. (Details are available on the ECOFIN webpage.)

Both TSCG and "six-pack" are intended to run simultaneously in the future, reinforcing the one another and subsequently creating the bud-

getary stability and competitiveness environment conducive to the stabilization and growth in the common currency area.

The third "long-term" set of the new policies is the so called European Semester. It introduces the cycle of the economic policy coordination via the processes of consultation, evaluation and adjustments of national budgets. The goal is to ensure the more stability and a better synchronization of the national fiscal policies in the line with conditions and restrictions of TSCG (Heinen, 2010).

Together, these measures are designed to provide for the long-term stability of public finances and the deepening of the policy coordination and mutual surveillance processes in the Eurozone. In this sense the TSCG, "Six-pack" and the European semester taken together can be considered as steps toward the some sort of the fiscal union, going significantly beyond the original SGP.

In this context the two aspects of the above mentioned "triad" (TSCG, "Six-pack" and the European semester) should be stressed. The first is that the politically very important concept of EU (and Eurozone) as the community of the intergovernmental treaties is preserved. Even the Triad's dominant element (TSCG) is based on the idea that its rules, restrictions and regulations will become the organic parts of the individual nations legal systems – preferably constitutions.

Secondly, no resource transfers beyond the previously existing agreements (preexisting EU budget, regional and convergence funds) are either involved or envisaged. Significantly, within the agreed upon fiscal limits and surveillance procedures, the structures of taxation and spending remain solely in national jurisdictions, reflecting the diversity in national preferences, history, culture and differing political constraints.

All measures described above – ESFS and its "successor" ESM and the "triad" – constitute the framework designed to address the perceived shortcomings of the Eurozone's architecture. The purpose is twofold. On the one side it is to provide for the medium to long-term enforceable stability of public finances, preserving to a significant degree the autonomy and decision making structures of the participating states. On the other side, the ESM provides the institution designed to deal with unpredictable structural shocks to the member states finances.

### 2.2.5 Where from Here?

Many analysts and commentators consider the above described "new Eurozone stability architecture" insufficient. The criticism is levied on several levels.

As far as immediate (i.e. the short-term) problems are concerned, the main criticism is the lack of policies designed to address the incipient banking crisis in Mediterranean littoral countries. (EU summit in June 2012 supposedly addressed this question be deciding to create the EU (or the Eurozone) bank supervisor and to initiate a speedy creation of a "banking union", aimed not only at the banking supervision, but at the creation and the funding of the resolution mechanism for the failing banks as well. However, this intention encounters serious difficulties and appears to be stalled at the time of this writing.) The basic argument here is that without addressing the incipient banking problems the mutual dependence between banks and public sector accounts in the Mediterranean littoral countries will lead to the deterioration of the positions of both. Such a deterioration then could make the above described "Eurozone stability architecture" both brittle and insufficient, increasing the likelihood that one or more countries will seek the solution of their difficulties outside the common currency framework.

As far as the medium to long-term Eurozone's outlook is concerned, the majority of opinions stress the need for – and hence the lack thereof – a deeper integration of the economies sharing the common currency. The buzzwords here are the fiscal and banking unions, but arguments often go beyond that. The good representative opinion here is Nicholas Veron (2012a). He stresses the desirability of the establishing the "four unions" – fiscal union, banking union, competitiveness union and the political union. At the root of this argument (and others in similar vein) is the conviction that the monetary union cannot strive in the environment of the decentralized economic decision making, with only limited constraints and coordinations provided by the intergovernmental agreements like TSCG and the "European Semester" processes and the explicit ex ante limits on the debt sharing and interstate transfer payments.

Finally, the problem which cuts across both the short-term and the longer term concerns. In the heart of the efforts to move away from even the enhanced interstate cooperation and toward more genuinely transnational, pan-European structures are the issues of the transparency and democracy on the Eurozone (and, indeed, the EU) levels.

### What to do Now

Economically, the immediate (i.e. the short-term) problem is to achieve a certain degree of stability in the Eurozone and to arrest the succession of "crisis shocks". One would surmise that the current "Eurozone Stability Architecture" (the "triad", ESM and the OMT policies of the ECB) can provide for the Eurozone without the undue crisis dynamics in the immediate future, provided that:

a) The existing arrangements, treaties and policies will be observed in the letter (i.e. not only in "spirit").

b) The independent audit of the Spanish banks is realistic – i.e. the refinancing need is 60 billion euro, covered by the 100 billion promised loan to the Spanish state from the ESM.

c) Some solutions can be found for the deteriorating Greek situation – solutions which will not trigger a "contagion crisis" in other countries on the Mediterranean littoral.

The greatest short-term danger to the current arrangements – and hence to the short-term stability of the Eurozone and the common currency euro – are political. The stabilization policies generate a lot of resentment and the growing political opposition not only in Greece and Spain, but in Portugal and Italy as well. Moreover, the need to stabilize the Greek Cyprus and Slovenia, albeit economically trivial, may pose a large moral hazard type of threat to the existing stabilization arrangements in the "problem" countries.

The basically political nature of these threats makes them inherently unpredictable. Hence the short-term stabilization requires a supportive long-term design, aiming at not only the fiscal and financial (i.e. the banking) stabilization, but at the arrangements which will restore the economic growth – and therefore the "real convergence" – in the "crisis countries" of the Mediterranean littoral. The issues of the competitiveness, capital flows and, indirectly, the resource transfers must be addressed in the medium to long-term horizon.

### Medium to Longer Term

Whereas the current arrangements can provide a certain modicum of stability for the Eurozone in the short-term, they are inefficient and perhaps even counterproductive in the medium to long-term horizon. The reason

is that the current approach relies significantly (and, indeed, inevitably) on the fiscal and financial restraint, combined with some structural reforms (especially in the labor markets, pensions, healthcare and education). Official resource transfers are limited and strictly conditional (both ESM and OMT). The result is the prolonged period of economic sluggishness, with a high unemployment, reduced pensions and social services and very slow (if any) competitiveness adjustments.

The longer this reality prevails the weaker will be the political support for the current arrangements. And, indeed, the higher is the probability that some countries will seek solutions outside the current arrangements – which inevitably means outside the common currency. Many hope that this quandary can be solved by a restoration of the economic growth worldwide. But this is probably naïve. Moreover, the renewed world economic growth may exacerbate rather than solve the Eurozone's competitiveness cleavage (Chen, Milesi-Ferretti, Tressel, 2012) and hence to intensify rather than mitigate the political pressures in some (Mediterranean littoral) Eurozone countries.

The key to this problem – and hence the key to the preservation of the Eurozone in anything close to the current configuration – is the restoration of the economic dynamism in the EU, especially in the Mediterranean littoral countries. And that requires an improvement of the competitiveness in the dynamic sense – i.e. the growth of productivity. Resulting economic growth would then address the fiscal issues, even within the confines of the TSGC. Structural reforms are, indeed, necessary. But they should be accompanied by investments into the productivity enhancing activities. And that requires the restoration and the dynamic stability of the (North to South) capital flows.

Most analysts address the issue of the medium to long-term stability (and survivability) of the Eurozone by pointing out the need for the fiscal and banking unions to complement the monetary union. Details of individual opinions differ, but the basic idea is the "need" to pool the resources both to pool the risk (in order to reduce the financing costs for the Mediterranean littoral countries) and to facilitate the resource transfers deemed necessary to stabilize both the fiscal position and the banks in the Mediterranean littoral countries.

"Fiscal Union" proposals are generally centered on the idea of so called "Eurobonds" – i.e. the replacing the individual national debt (or the parts thereof) with the common pool and the common responsibility for the debt service and redemption. (See Claessens, Mody, Vallee, 2012,

for the discussion of the most "popular" proposals.) The stated aim of all proposals is to reduce the debt servicing costs for the Mediterranean littoral countries. The basic argument for the Eurobonds and the "fiscal union" in general is emotional and political rather than economic. It is asserted that the fiscal centralization is needed to complete and stabilize the currency union. Assuming that the strict limits and procedures as agreed (Triad, ESM) are observed in the fiscal area and the structural reforms are implemented, the fiscal union (in the minds of its advocates) should provide for a financeable public debt (it should deter the financial "speculation" against the debt of weaker countries and hence provide the needed fiscal stability for not only the Mediterranean littoral countries, but for the Eurozone as a whole). By arresting the "danger" of the Eurozone disintegration, the Eurobonds (i.e. the "fiscal union") should facilite (together with the "banking union" – see below) the return of the private capital inflows and hence the economic growth into the Mediterranean littoral countries.

Basic objection to the "Eurobonds idea" is that it provides for the implicit resource transfers (something which is illegal under Maastricht treaty) and hence it constitutes the moral hazard by encouraging the "irresponsible" fiscal behavior in the Mediterranean littoral countries.

(One has to realize that by pooling the resources – and hence the interest rates on debt – northern countries would have to pay relatively higher interest rate on their Eurobonds borrowing whereas the Mediterranean littoral countries would pay less – clearly a resource transfer. Note that this would happen even if everybody served punctually his Eurobond obligations. Moreover, given the lower costs (interests payments), the more credit constrained countries would have a tendency to borrow more, increasing the implicit liabilities of all countries (hence again an implicit transfer) under the joint and common liability. One may argue that the latter problem could be solved by the Eurozone centralized individual countries budget surveillance and the common "budget resolution process". However, the permanent restrictions on the national sovereignty any such arrangement would entail is currently probably outside the realm of the politically possible.)

The alternative approach to the "fiscal union" idea is the concept of the common Eurozone budget (Van Rumpuy, 2012a). This idea (admittedly in a very embryonic stage) seeks the closer coordination of individual national budgets and a "harmonization" of tax systems, welfare and labor markets reforms, pension schemes and retirement age etc. on the Euro-

zone level, with perhaps a common decision making and enforcement mechanism (via "binding contracts") on the Eurozone level.

Again, this idea assumes the transfer of the significant portions of the national sovereignty to the Eurozone level, something which is rather unlikely to happen in the foreseeable future. Moreover, the (rather implicit) creation of the – albeit embryonic – "Eurozone superstate" raises the question of the role and the overall position of the non-Eurozone EU members. And this is the issue over which perhaps more than often threatened "collapse of the Eurozone" could pose the existential threat to the EU itself.

The basic problem for almost any "fiscal union" concept for the Eurozone is the lack of a political arrangement enabling both the concentration of the fiscal decision-making on the Eurozone level, legitimizing the resource transfers inherent in any at least marginally effective "fiscal union" arrangement. And, indeed, there seems to be an equal lack of the political will to proceed with the Eurozone-wide structural reforms and the harmonization in the areas of taxation, pensions and healthcare provisions, labor markets, budgetary procurements etc. But without reforms in these areas any attempted "fiscal reform" will remain a hollow shell.

The "banking union" is the issue that many analysts and commentators consider perhaps the more important than the "fiscal union". And certainly the more urgent. The reason for this attitude is threefold. On the one side many point out that the balance sheets of many banks, especially in the countries on the Mediterranean littoral, are burdened by the bad assets and the increasing percentage of non-performing loans – a situation which threatens a chain like banking collapse which may spread across the Eurozone (via the system of the interbank lending and borrowing). Under the existing arrangements, the refinancing and restructuring of the impaired banks is under the jurisdiction of the national governments. However, individual governments actions to refinance the national banks (in order to prevent their collapse) increases the public accounts deficits and debts to a degree which may threaten a country's compliance with the TSGC treaty (and hence to unravel the keystone of the Eurozone stabilization policy).

The second reason is related to the first. Given some countries limited and costly access to the financing (and refinancing) of their public debts, the domestic banks became the major – and sometimes the only – source of funds. That increases the degree of the interdependence between

the sovereigns and their banks. In a "bad equilibrium" the sovereigns problems worsen banks balance sheets and vice versa. Many fear that in the extreme situation this might lead to the euro exit – simply the need to save domestic banks both as a source of public financing and (more importantly) the private credit outweighs the projected costs of the euro exit.

And finally, the perceived threat to an euro exit and the banking instability leads to a capital outflow (i.e. the deposit flight) from some countries (Greece, Spain). That not only worsens the bank balance sheets in those countries, but, more importantly, increases the Eurozone financial sector fragmentation. And the latter makes the euro exit more feasible.

The analysts usually describe the "banking union" as having five elements (Liikanen, 2012, Pisani-Ferry, 2012, Pisani-Ferry and Wolff, 2012, Vives, 2012): Common supervision, resolution mechanism, deposit insurance, fiscal backstop and the "lender of last resort".

The creation of a common supervisor was agreed upon at the EU summit in June 2012. But the effective common supervisor requires reasonably common rules, an unlimited access to bank documents, commonly agreed definitions of assets riskiness and the last but not least, the independence of the other elements of the "banking union". The last characteristic is of the paramount importance if the centralized banking supervision is not to become the toy in the hands of national cum political interests.

The resolution mechanism (i.e. the way how to address the individual banks problems identified by the common supervisor) not only requires the common rules (reconstruction, mergers, refinancing, liquidation), but in the present situation would imply a resource transfer to the Mediterranean littoral countries. To decide on such transfers by some "expert" group with no democratic input and supervision (centralized bank supervisor) is the recipe for unending political conflicts which more likely than not would lead to the collapse of the "banking union".

The centralization of the deposit insurance requires more than the pooling of the existing deposit insurance schemes. Given the existing wide diversity in this area, some harmonization of the scale and scope between the individual countries may be required. But, perhaps more importantly, given the asymmetric nature of the ongoing crisis (both banking and fiscal), the pooling of the national deposit insurance funds implies a resource transfer (implicit, but it may become explicit should the deposit insurance be used). Moreover, the pooling of the deposit insurance may encourage an increased risktaking by institutions in difficulties.

Indeed, the possibility exist – especially in the short to medium term horizon – that the resolution requirements or even the deposit insurance commitments can be short of funds. (After all, the most likely way how to establish the funds of the needed size are "insurance premia" paid by the financial institutions covered. But it takes time to build such a fund to the required size.) In such a case, the "fiscal backstop" – i.e. the publicly financed fund would be needed to make the "banking union" a credible and hence the market stabilizing arrangement. Such a fund can be established by the governments dedicated contributions. (Basically the loans to the fund which would be gradually repaid by the financial institutions "insurance premia" over time. Assuming indeed that no "insurance event" would occur which would exhaust the fund before it is fully self-funded.) In any case, the "fiscal backstop" – i.e. the governments' commitment to provide funds if no other source is available – is the crucial and irreplaceable key to the "banking union" credibility.

But this implies the connection between the "fiscal" and "banking" unions and hence the need to discuss, analyze and, if feasible, propose both of those unions together. (Pisani-Ferry, Wolff, 2012) But perhaps more importantly, the need for a fiscal backstop implies the need for public funds – again implying the requirement for resource transfers.

The lender of last resort is the standard function of the national central banks, designed to prop up the financial institutions which are basically solvent, but may be temporarily illiquid. Transference of this concept to the Eurozone level seems obvious to many analysts, especially if considered a part of the "banking union" (Wyplosz, 2012). However, in the context of the Eurozone, the idea of the ECB acting as the lender of the last resort remains controversial. (De Grauwe, 2011) The problem is the close (some may even call it incestuous) relationship between the banks and sovereigns (respectively sovereigns debt). Given this relationship – especially pronounced in the Mediterranean littoral countries – acting as the lender of last resort comes perilously close to the monetary financing of an Eurozone member state debt by ECB. The strict ban on such a financing is the cornerstone of the European monetary union (even if some analysts argue that this ban was violated by the recent ECB actions). (Buiter and Rahbari, 2012)

Indeed, assuming that the connection between the sovereign debt and banks is eliminated (i.e. sovereigns must borrow on the open bond market only) and other above mentioned elements of the banking union are in place, the ECB may, and perhaps should, undertake the lender of last

resort function. But even then it may violate the Maastricht treaty – hence the treaty change may be necessary.

Again, the basic problem for almost any marginally effective "banking union" concept for the Eurozone is the lack of the political arrangement enabling the concentration of the financial resolution and the deposit insurance on the Eurozone level. This is (again) due to the implied resource transfers inherent in any such arrangement.

The analysis up to this point indicates that whatever the actual forms, the basic characteristics of both fiscal and banking unions are the resource transfers (implicit or explicit) from the core (Northern countries) to the countries on the Mediterranean littoral. To facilitate such transfers, the legitimizing political arrangement – often called the "political union" – of the Eurozone countries is necessary. And, indeed, the establishment of the EU as a political union is the dream for the hard core Europeanist.

The concept is not new and was, in fact, the subject of both the political (Lindley-French, 2012, Kundnani, 2012) and the professional (De Grauwe, 2010, Issing, 2012) discussion recently. Some commentators consider the political union a sine qua non for the survival of the common currency, whereas others view it with strong misgivings and skepticism.

Indeed, the problem is not the concept as a such, but (and this is extremely important) the governance of the such a hypothetical union. In the member states of EU, the political governance and the decision making processes are legitimized – and the results generally accepted – by the open and transparent democratic traditions. That implies that the decision making processes are open to a popular control and (sometimes) reversals – via the regular and repeated elections. And, indeed, the role of traditions and the national cohesion should not be underestimated. This then facilitates that an "unpopular" decision can gain a majority political support by the populations via their representative structures (like resource transfers etc. – i.e. the German unification process or the Italian North-South transfers).

Can this structure be "telescoped" to the Eurozone (or the EU) level? Unlikely. Simple numbers show that whereas in the EU there are about 110 000 citizens per MP, in the EU parliament, with 745 deputies, the corresponding number is 674 496. (Numbers are from Lindley-French, 2012.) To maintain the "average national representativeness" on the EU level, EU parliament would require 4000–4500 deputies – obviously an unworkable proposition. Moreover, given the lack of the national,

cultural and social cohesion and the common interests on the EU level, the rules which would protect the overrides of basic national interests would make the common EU institution non-functional.

It follows that, given the current circumstances, a democratic and transparent transnational European governance structure – i.e. the one which could decide about the resource transfers and whose decisions would be generally respected – is very unlikely, if not impossible. That of course implies that any significant moves toward the comprehensive fiscal and banking unions for the Eurozone would have to be done on the intergovernmental level. The rejection of such agreements by the courts or electorates of one or more Eurozone member countries is likely. (The ill fate of the "European Constitution" in 2005 should serve as the warning here.)

## 2.3 Conclusions

Analysis in this chapter indicates that: (i) The existing arrangements ("Triad", ESM, OMT) should be able to provide for the short-term stabilization of the Eurozone, provided that the agreed upon measures are adhered to; and (ii) relying on the establishment of the fiscal and banking unions in order to provide for the long-term stability and economic dynamism of the Eurozone may be unwise and possibly even counterproductive.

The reason for the latter is that a sort of the political union is necessary if the required resource transfers are to be legitimate (and hence to gain the needed political support). But this is practically infeasible both today and in the foreseeable future. This reality then leads many to the conclusion that the Eurozone in its current configuration cannot survive and the substantial restructuring is absolutely necessary.

In searching for solutions it has to be realized that the essence of the Eurozone crisis are growing divergencies between the "Northern core" and "Southern periphery". To address (and hopefully to reverse) this problem, the restoration of the economic dynamism in Mediterranean littoral countries is required. Structural reforms are obviously necessary, but so are investments (i.e. the restored capital inflow) to increase the productivity and hence the competitiveness and income and tax revenues generating capacity of the population of those countries.

So, perhaps instead of grand schemes (fiscal and banking unions) which are so complex that there is always a danger of getting things wrong)

a set of smaller steps and limited arrangements could be introduced aimed at the restoration of the capital flows and other competitiveness elements to the countries on the Mediterranean littoral. (Incidentally, if successful, these would substitute for the involuntary resource transfers which – implicit or explicit – are the essence of the proposals for the fiscal and banking unions and simultaneously the biggest obstacle for the establishment of these unions.)

Perhaps the first arrangement to be explored (and hopefully implemented rather fast) is the idea of a "competitiveness union" (term introduced by Veron, 2012a, and recently, in somewhat different form, advocated by Van Rompuy, 2012b). The basic idea is the harmonization of labor laws, taxation, regulations etc. toward some Eurozone standard. The commitment to these policies could be enhanced by the binding treaty – perhaps an amendment to TSGC. To facilitate the progress in this area and to enhance the democratic supervision and transparency, a "Competitiveness Board" could be created, voted in (with membership of a fixed term) by the European Parliament. Such a board would have a clear task, established by the European council say on the bi-annual schedule. After being elected, its members would be independent and could not be recalled, baring special circumstances. The board could impose penalties if the agreed upon goals and commitments were to be neglected by the national governments who committed to them. The advantage of this arrangement is that it follows the established precedent of other EU treaties and institutions (TSGC, ECB), implies no resource transfers and basically follows the concept of the EU as the set of the intergovernmental treaties – i.e. avoids the controversies and conflicts associated with the centralization implicit in the "political union". Moreover, it should create a political and economic environment conducive to other two proposals below.

Any improvement in competitiveness of countries on the Mediterranean littoral implies the need to increase the productivity in the tradeables sector, which in turn implies the need for higher investments. Capital flows into these countries should be restored. However, they should be channeled into the productivity and competitiveness enhancing investments. (As discussed above, capital inflows in the 1999–2009 period went mostly into consumption. This was, indeed, the main cause of the current crisis.) To facilitate the "productive" capital flows in the future, perhaps an "investment union" should be considered. A possible organizational form could be the establishment of perhaps several "investment funds". These could be formed as public-private partnerships. The pub-

lic participation could be financed from the current account surpluses of the "Northern" countries, but other forms should not be excluded. As far as these "investment funds" would aim at the financing of the profitable endeavors with a positive expected return (hence the term "investment"), it should have an ability to attract the private participation – i.e. to leverage itself, something which eludes (for a good reason) to ESM.

Indeed, these funds would be the resource transfers by design. However, as long as their activities are carefully planned and both ex ante and ex post profitable, this should present no problem. (Note, it is not a resource transfer to finance bail-outs, but basically the capital seeking return opportunities.) The "competitiveness union" discussed above should be instrumental in facilitating these "investment funds" by creating the environment conducive for the profitable business activity. To encourage the participation, the private partners could be offered tax incentives. The loss of the tax revenue could be then compensated by returns on public participations.

The advantages of these "investment funds" would be twofold. They could be established with a very minimal need to alter or amend the existing EU treaties – hence no need for the political union necessary for effective fiscal and banking unions. And indeed, they would enhance the economic dynamism in the Mediterranean littoral countries. Higher growth means more tax revenues (and lower unemployment). That would enable a more stable fiscal environment in those countries, helping to address the "legacy assets" issues and hence to stabilize the Eurozone as a whole.

The third of "small steps" is for the EU and the Eurozone authorities to engage in the active support and promotion of the venture capital funds, especially those whose activity is aimed at the countries in the Mediterranean littoral. The major act in this would be the integration of the Eurozone's financial markets – both administratively and via the binding common rules, settlement procedures, trading regulations etc. That, together with the above mentioned "competitiveness union" should facilitate the new, innovative and dynamic private business creation in the Mediterranean littoral countries, creating the more opportunities for the "investment funds" as well.

Again, this step basically preserves the existing governance structures of both the EU and the Eurozone. Resource transfers would certainly be involved, but, being strictly market based, would not involve any

"involuntary" commitments of public funds. And, again, if successful this step would enhance the economic dynamism in the Mediterranean littoral countries with all its positive results not only for those countries but for the Eurozone as a such.

The key to the preservation of the Eurozone in anything resembling to the current configuration is the real convergence. The prevailing ideas of the fiscal and banking unions may contribute to this result, but only if they facilitate the long-term officially sanctioned resource transfers from the Northern core to the countries in the Mediterranean littoral. That then requires the political union – an arrangement appealing to some but unfeasible in the current reality (Issing, 2012). This chapter tries to suggest a possible alternative. Can it work? Let us hope so, because otherwise we better get ready for the radical Eurozone's restructuring. Caveat consules!

## 2.4 References


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# 3 Neo-Liberal Corset-Policy and European Inflation-Phobia

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## 3.1 Introduction

Basic macroeconomic accounts provide a straightforward explanation for the appearance of twin deficits. As the inflow of goods and services exceeds the outflow of exports, domestic absorption goes over domestic production, which either means vigorous investments in the private sector and/or public expenditures exceeding the revenues of the public budget. Correspondingly, public deficit means a crowding-out absorbing part of private savings and/or domestic state borrowing from abroad.

In general, current account deficits within a monetary union should not be a problem. Yet, there are two preconditions for that. On the one hand, *an efficient institutional background is needed in order to provide a socio-political legitimization of the capital flows, while on the other, the deficits that arise in specific regions of the union should be convenient, given the intra-union and the international circumstances.* Recall that the current (capital) account of one member-country is not necessarily the exact opposite of that of the other, since all members do not trade exclusively with each other. Therefore, if a country runs explosively rising current account deficits, this will, sooner or later, generate the corresponding financial speculations from outside, which may provide great concerns to the rest of the union.[6]

Unfortunately, both preconditions do not apply fully in the case of the European Union (EU). With respect to the first, there is an indisputable policy lack in the institutional architecture. In addition, this minimum degree of political consensus has an obvious, predetermined neo-liberal character, distanced even from the historical, bourgeois democratic acquis. As for the second, given the financial constrains provided by the

[6] There is an obvious analogy in the cross-regional distribution of resources within a single autonomous state.

global systemic crisis, any exaggerated current account deficit might generate problems in refinancing the seemingly manageable debts of other member-countries too. Cases like Greece spoke about the possibility that the *King might be naked,* leading to a spiral of aggressive speculations, boosting the costs of borrowing for the Union as a whole.

## 3.2 The Neo-Liberal "Union" – A Diverging "Union"

### 3.2.1 Is Europe Growing Faster?

The neoclassical paradigm favours internationalisation: opening up markets is effective and desirable – enhancing the degree of international competition will boost economic growth and initiate convergence. EU serves as a historical experiment for the formation of a nearly perfectly internationalised environment, in the terms of the neoclassical perception. Bearing in mind the subsequent institutional steps that have been made in the last five decades, we consider the Union, especially Eurozone, as the outcome of a regionally evolving globalisation process. Thereby, it offers an excellent opportunity to check the validity of those arguments that back up the neo-liberal political transformations.

Since the 1980s, a vigorous discussion was developed (Romer, 1986) concerning the growth effects in a progressively globalized environment. Subjective reasons – answering the specific questions relates strongly to various socio-political interests – but also objective ones – like the differences in the underlying theoretical assumptions, the variables used, the sample and the statistical data, as well as the econometric techniques applied – generated a variety of partly controversial empirical results and arguments. Although the dominant position seems to be that trade contributes significantly to the strengthening of growth, there are many other studies, which either show no relation, or, worst, relate trade and growth in a significantly negative way. Both, the sign and the causality of the effects, vary accordingly to the country and time period (Khalafalla and Webb, 2001), denoting that a range of time and region specific socio-economic conditions are of great importance (Levine and Renelt, 1992, and Chuang, 2002).[7]

[7] Kali et al. (2007) gather all different thinkable reasons for having diversified empirical results regarding the growth effects of internationalization.

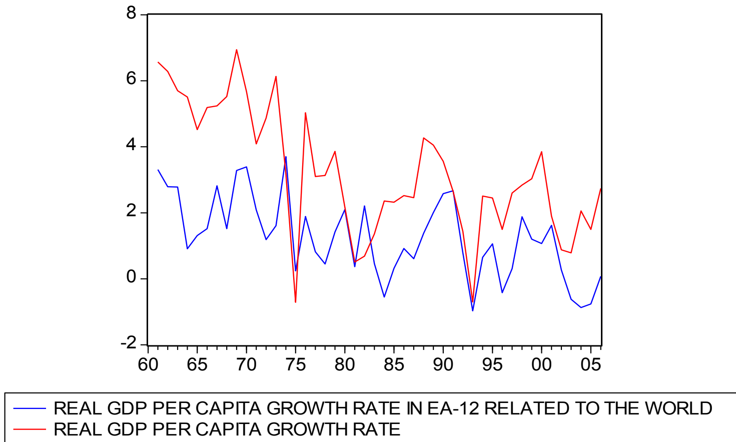


**Figure 6 Growth rates in Eurozone-12, relative to the world economy**

Source: Author.

Figure 6 illustrates the development of the annual growth rates for the Eurozone-12 as a whole,[8] both, in absolute percentages and in relation to the growth rate of world economy, from 1960 till 2005.[9] The estimations presented in Table 5 back up the conclusions one might derive from the figure: Eurozone and especially some specific countries – Austria, Belgium, France, Greece, Italy, Portugal and Spain – show an increasing hysterisis compared to the world-wide growth rates. The opposite applies

[8] Opposite to Yin et al. (2003), we consider this group of countries over the whole period (1960–2006), regardless the time of accession. Economic and political co-operation evolves always much earlier than the official agreement.

[9] We use the AMECO Database from Eurostat. The discussion we provide should be considered as an effort to depict the relative growth perspectives of EU, and not as a thorough study of trade / growth relations (for a more systematic analysis see in Gkagka and Zarotiadis, 2011). Theory provides us with a range of arguments for why the unconditional, regionally unlimited expansion of trade is preferable compared to the one that results within the borders of regional agreements. In the European Union itself, Wooster et al. (2008) find that trade within the countries of EU-13 has less, yet still positive, effect on economic growth compared to the effect from trade with non-EU countries. Andriamananjara and Hillberty (2001) also noticed that trade relations strengthen domestic growth, especially when they apply to “third” countries, outside the borders of a regional trade agreement and economic integration regime (like the European Union).

only for Luxemburg and the exceptional case of Ireland. EU member states do not seem to gain much. If anything, despite (or because of) a regionally constrained process of internationalisation, growth has been affected in a negative way.

| Country | Stationarity | | | Trend Estimation | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | | | ADF (AIC) | | PP | | KPSS | |
| | ADF (AIC) | PP | KPSS | Coefficient | *t*–stat. | Coefficient | *t*–stat. | Coefficient | *t*–stat. |
| **Austria** | −3.40† | −6.30§ | 0.25 | **−0.04** | −1.84* | −0.02 | −1.22 | −0.02 | −1.36 |
| **Belgium** | −4.11‡ | −6.96§ | 0.06 | **−0.03** | −1.71* | **−0.03** | −1.81* | **−0.03** | −1.85* |
| **Denmark** | −6.60§ | −6.60§ | 0.05 | 0.00 | 0.07 | 0.00 | 0.07 | −0.00 | −0.24 |
| **France** | −5.91§ | −5.92§ | 0.05 | **−0.04** | −2.63** | **−0.04** | −2.63** | **−0.04** | −3.21*** |
| **Germany** | −5.24§ | −3.82§ | 0.25 | −0.02 | −1.23 | −0.01 | −0.87 | −0.02 | −1.35 |
| **Greece** | −2.18 | −5.94§ | 0.20‡ | −0.02 | −0.48 | −0.08 | −1.35 | **−0.07** | −2.08** |
| **Ireland** | −1.50 | −5.17§ | 0.07 | 0.12 | 1.61 | **0.08** | 2.51** | **0.10** | 3.58*** |
| **Italy** | −6.04§ | −6.02§ | 0.15‡ | **−0.05** | −2.43** | **−0.05** | −2.43** | **−0.06** | −3.46*** |
| **Luxemburg** | −5.56§ | −5.56§ | 0.11 | **0.07** | 2.07** | **0.07** | 2.071** | **0.08** | 2.76*** |
| **Holland** | −1.67 | −5.24§ | 0.08 | 0.00 | 0.04 | −0.00 | −0.27 | 0.00 | 0.14 |
| **Portugal** | −1.63 | −4.49§ | 0.06 | −0.04 | −0.97 | **−0.06** | −1.90* | **−0.08** | −2.62** |
| **Spain** | −4.62§ | −4.59§ | 0.13† | −0.02 | −0.81 | −0.02 | −0.81 | **−0.05** | −2.49** |
| **Eurozone** | −5.27§ | −5.27§ | 0.06 | **−0.03** | −2.85*** | **−0.04** | −2.85*** | **−0.05** | −4.85*** |

**Table 5 Trend estimation of GDP percent growth relatively to the world (1960–2005)**

Notes: †, ‡ and § denotes rejection of the $H_0$ of unit roots for Augmented Dickey Fuller (ADF) and Phillips Perron (PP) tests and rejection of the $H_0$ of stationarity for the KPSS (Kwiatkowski Phillips Schmidt Shin) test at the 10%, 5% and 1% significance level, respectively.
*, ** and *** denotes statistical significance at 10%, 5% and 1% significance levels, respectively.

Source: Author.

### 3.2.2 Is Europe Growing Equal?

Empirical evidence on convergence is even more contradictory, albeit standard growth theory unquestionably insists on the closure of gaps: as internationalisation proceeds, the socioeconomic, structural characteristics of different countries become similar. Thereby, region/country specific steady becomes similar too; our confidence in *"conditional convergence"* changes into a certainty of unconditional closure of cross-country inequality! Also from a static point of view, mainstream trade analysis implies for open economies the equalization of factors' remuneration in

real terms. Indeed, many authors concentrated on $\sigma$-convergence in Europe and provided evidence for closing of the gaps.[10] With respect to $\beta$-convergence, there are also studies with similar conclusions (Basile et al., 2001, Finleton, 2003, Yin et al., 2003, Desli, 2009), although some of them find sub-periods of weak divergence.

In contrast, a wide range of studies reject the convergence hypothesis for the EU, despite the gradually strengthening internationalisation. Most of them show an unclear development of $\sigma$ in time (López-Bazo et al., 1999, Barrios and Strobl, 2005, Cappelen et al., 2003, and Basile et al., 2001), while others (for instance, Neven, 1995) identify different patterns of convergence in northern and southern Europe, especially during the period 1975–1990. The contradictory results arise partly from using dissimilar sets of countries, but, basically, from covering different time periods. The picture we get from the aforementioned relevant studies is that something went wrong in the 1980s! Many of the researchers anticipated it,[11] but they thought of it as the result of a temporary effect: the big 1980–1982 recession, resulting from the continuously increasing oil prices, or the accession of southern European countries (Neven and Gouyette, 1994), were thought to be the underlying reasons.

Truly, this could be a valid conclusion for someone studying the period lasting, at most, till the beginning of the 1990s. In Figure 7, we plot the development of the annually estimated coefficient of variation[12] for real GDP per capita in the Eurozone-12, from 1960 till 2010. As one sees clearly, the problem with the 1980s was not a short-term break in a continuous trend, but a complete alteration of the process: a structural change from a previous sustained convergence into a persisting period of continuous divergence! In 1960s and 1970s, a convergence took place, as $\sigma/\mu$ started from 0.43 in 1960 and felt continuously to 0.31 in 1980. Yet, from the beginning of the 1980s, things changed dramatically: the

[10] Yin et al. (2003) focus in the period 1960–1995 and provide evidence for convergence, except for the period 1980–1985. Also Hoen (2000), who uses data from six core European countries (Germany, France, Italy, the Netherlands, Belgium and Denmark), claims that GDP per capita is converging in the period 1970–1985. Barro and Sala-i-Martin (1991, 1995) found the same among European regions for a wider period (1950–1990).

[11] Giannias et al. (1999), for instance, speak about a convergence process, which is disrupted in the early 1980s.

[12] Many empirical studies use the same indicator (standard deviation divided by the mean) in order to search for $\sigma$ convergence: Rowthorn and Kozul Wright (1998), Veiga (1999), Fingleton (2003), Soukiazis (2003), Beckfield (2004), Kenny (2005), Tsagkanos et al. (2006), Studer (2008).

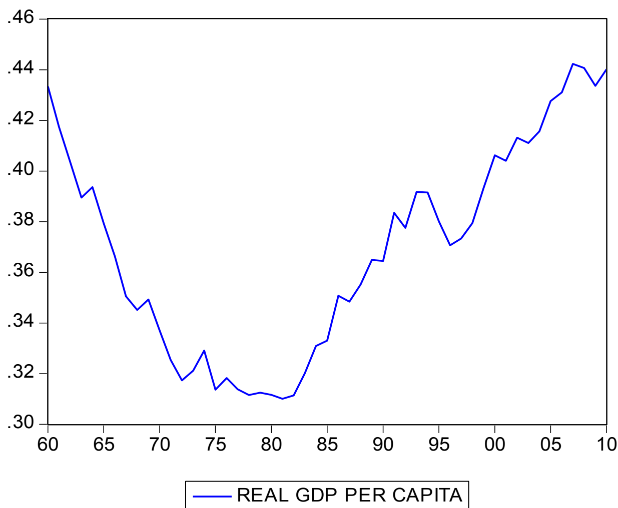


**Figure 7** **$\sigma$-convergence of per capita GDP in Eurozone-12, 1960–2010**

Source: Author.

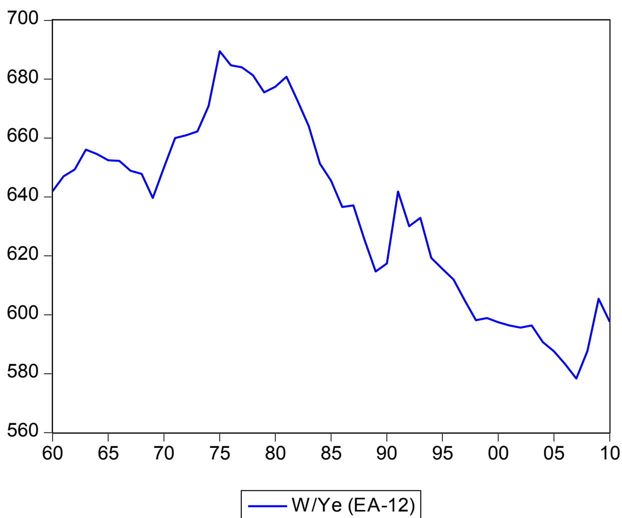


**Figure 8** **Adjusted wage share in Eurozone-12**

Source: Author.

coefficient of variation rebounded and followed an upward tendency, so strong that it grew back to 0.44 in 2010. Using Perron-test, structural change is being confirmed and appears in 1981.[13]

Despite the cross-regional dimension, inequality should also be checked with respect to the remunerations of the different production factors. Recently, the OECD published a study claiming that economic growth in developed countries goes together with a deepening of domestic inequality (OECD, 2008). ILO (Global Wage Report – 2008) reports that a 1% GDP growth has been associated on average with a 0.05% decrease in the wage share. Hereupon, we depict in Figure 8 the annual development of the adjusted wage share, which is defined as the ratio of real compensation per employee over real GDP per person employed ($w/y_e$) for the Euroarea-12 as a whole. This ratio serves as an indicator of functional income distribution and a *"fair share"* for workers.[14] In other words, it points labour's position in the distribution of income.

Figure 8 confirms the findings of the OECD, yet only for the second half of the period: being in remarkable conformity with the development of cross-country inequality ($\sigma$-divergence), labour's relative income improved during the first two decades. But, starting from the 1980s, European workers get a progressively smaller share of produced output. As the share of workers is, if anything, not decreasing, the worsening of labour's position in the imperfect labour market is the only reasonable justification for the fact that real wages lost about 10% compared to GDP per person employed over the last three decades. Also here, the Perron test shows a significant structural change around 1978.

## 3.3 The Neo-Liberal Maturity

Neoclassical theory lays great emphasis on the efficiency of internationalization with respect to the closure of gaps, as well as to the growth perspectives for the participating economies. In the previous paragraphs, we saw that both arguments are being disputed. Eurozone countries do not seem to gain much from it, or at least not as much as they could: they grow with gradually weaker rates compared to the world, while they

[13] In the present discussion, we provide a descriptive analysis. For a more thorough study, see in Zarotiadis and Gkagka (2010).

[14] This is because a declining wage share usually implies that a larger share of the economic gains is directed into profits. Not only may this be seen as unfair, but it can also have an adverse impact on future economic growth (ILO, 2008).

undergone a strong diverging period after 1980. The previous trend of closing the gaps reversed completely, and both inter- and intra-regional inequality deepened. In 1974 the ECU (European Currency Unit) was defined and on the 13$^{th}$ March 1979 the European Monetary System (EMS) entered into force, according to an agreement observed on the same day between the central banks of the member-countries. Close to that, the treaty of Maastricht inaugurated the neo-liberal *"corset policy"*, which is being followed even today. Europe came into a new historical phase of centralization and declining democratization: monetary policy has been transferred to the jurisdiction of European Central Bank (ECB) and Brussels' bureaucracy that follow dogmatically the sclerotic and arbitrary financial commitments of the Treaty. Is this simply a coincidence?

In fact, empirical observations support our main suspicion: apart from the *"growing unequal"* hypothesis that refers to all the western economies, the gradual transition of the European free trade area into an economic and monetary union, accompanied by the prevalence of a specific policy, explains the occurrence of a period of deepening divergence since the beginning of the 1980s.

### 3.3.1 European Inflation-phobia

Current accounts were never an issue for the Eurozone: over the last decades and even in the most recent period, deficit fluctuated below 1% of GDP, with the exception of 1995 when it exceeded 3%.[15] This speaks for an easy way to deal with the arising high deficits of specific countries: simply, cover them internally by issuing more of the common currency and proceed with any necessary intra-union political agreements that would motivate the specific member to overcome the existing deficiencies, and to develop production facilities. Instead, the technocrats of the Eurozone led the naively unsuspecting political leadership of the Member States to the arms of the voracious "secondary market". This option was mainly justified by the supposed risk for inflation and the financial instability.

Like all "phobias", *European inflation-phobia* has a rational basis, which, however, as it is partly deliberately exaggerated, it ends up being a

[15] For most recent data see in the report for the first estimate for the third quarter of 2011, Eurostat Newsrelease Euroindicators 181/2011 – 9/12/2011 (epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/2-09122011-AP/EN/2-09122011-AP-EN.PDF). Also, see in Barrios et al. (2011) and in Schmitz and von Hagen (2011).

psychological phenomenon. Indeed, the latest European history has a lot of inflationary aberrations, result of economic competition and warfare, where the thoughtless, expansionary monetary policy was one of the key instruments in an attempt to impose one another.[16]

Upon this historically initiated and politically exploited phobia, builds a clearly rational behaviour of the wealthier, highly developed economies in the Union: over-evaluating inflationary risks in a time where average inflation rate in the Eurozone is hardly above zero, is not simply the result of an irrational fear. From their point of view, given their pre-existing international competitiveness, the common currency is already underrated. A monetary expansion, even if it could be a more secure way to cover the deficits produced elsewhere, it would provoke losses in the relative value of their exports, as well as losses in the ability of their accumulated capital to acquire assets abroad. On the other, this would harm the one and only reason for which central Eurozone banking systems keep on attracting liquidity: despite extremely low interest rates, in the German, French banking sector flowed since 2009 268 and 324 billion euro respectively, simply because of the provided relative security! Reversing this trend could be especially harmful, even more as total liabilities of the banking sector surpasses 250% of Eurozone's GDP.

### 3.3.2 Corset-policy: Transforming a Keynesian Co-operation into a Neo-Liberal Union

Aside to the necessary, from a systemic point of view, strategy for motivating the over-accumulated, over-spoiled financial capital to be re-invested, inflation-phobia and the rationales hiding behind provide good reasons for the neo-liberal transformation of the Union and the dogmatic persistence on *tying up the corset.*

EU was rooted in the Economic Cooperation Act of 1948 (Marshall Plan): a Keynesian strategy of international orientation laid the eventual unification of European countries. In the meantime, Keynesian economics were grafted with the *"continental"* tradition of bourgeois liberalism, leading to what literature calls *"Europeanization".* All these changed around the 1980s. The recent transformation into a neo-liberal monetary union is in absolute accordance with the overall evolution of the pro-capitalistic political scene of our times.

[16] Look in www.britannica.com/EBchecked/topic/195896/history-of-Europe/58337/Prices-and-inflation for a well structured, introductory historical presentation.

Neo-liberalism is the necessary response to post-imperialistic capitalism, given the rapid deterioration of the systemic bottlenecks. As the geographical and credit expansion reached their limits, as technological evolution diminishes marginal costs and counteracts commercialization, the only way-out is the alleviative self-destruction of the production means. Nevertheless, it had to go through a necessary lifting, since the last historical experiences along with the tremendous evolution of military forces impose us to be more careful. Neo-liberalism is nothing as simple as that: an attempt to form new prospects of rewarding re-investments for the internationally over-accumulated capital that has been spoiled by the excessive profits of financial speculations. In order to succeed, it sacrifices the small and medium-sized businesses (SMB), deregulates branches of the public sector and abolishes the structures of the European social state, which have been the result of historical, systemic compromises. Thereby it recreates a new *"el-dorado"*, so very needed in a time of deepening inequality, overproduction and over-accumulation of capital.

This explains the threefold character of neo-liberalism: first, the dogmatic insistence for deregulations – locally or internationally; second, the almost perverse preference for financial capital and the aversion against the productive SMB; finally, the intolerance towards the traditional bourgeois state. European representatives of modern apologetic policy abnegate even the deepest bourgeois-democratic traditions. The historical *"European Acquis"* for democratic legitimation is being totally rejected.

For instance, the decisions taken in the European Summit of 9$^{\text{th}}$ December 2011 are revealing. The 17 members of the Eurozone concurred on a new intergovernmental agreement to impose constitutional restrictions on the national budget deficits. The experience of Maastricht was not enough – dogmatic political agents keep on believing that tightening the *"corset"* will automatically solve any existing problems and inefficiencies. German Chancellor leaves no doubt: *"We have achieved a breakthrough to a stability union. A fiscal union, or stability union as I call it..."* Setting *"fiscal union"* equal to *"stability union"* is one of the most efficient ways to express the paradox of the neo-liberal doctrine.

Recall also another decision, which, however, did not receive the appropriate attention. In the same summit, the European Stability Mechanism (ESM) was to enter into force by 2013, when the European Financial Stability Facility (EFSF) and European Financial Stabilization Mechanism

(EFSM) expire. Decisions at the ESM, as to where money goes, will require an 85 percent majority, yet, of the contributing capitals! Truly, this is not very far from linking a citizen's vote directly to his income-statement.

Having this in our mind, the fact that Brussels bureaucracy and the representatives of internationalized financial capital deny the basics of bourgeois political ethic should not surprise us: they impose governments consisting of technocrats, or, even worse, they naively try to secure the policy they impose by demanding the signature of political parties, ignoring the sovereignty of the citizens. Not because of a devilish treachery against the historical socio-political consensus of primitive bourgeoisie, but due to an ingenious insistence on the neo-liberal prescription of alleviative self-destruction. Often, especially in times of deep crises, political agents come-up with hasty choices, putting in danger the system they wish to serve. Hence, critiques repeatedly arise from inside – not only from competitive political groups, but from the neo-liberal consultants themselves. Peter Bofinger, a member of Germany's *"council of five wise men"*, stated clearly that *"the 'problem countries' ... have done a lot to redress their deficits"* and that Chancellor Merkel is too timid: *"It is difficult to convince the average German that this solidarity is needed. It needs courage to say this, and this courage is not there in a sufficient amount."*

## 3.4 Conclusions and Proposals

The Eurozone as a whole seemed to be financially self-contained – even today, despite the severe financial circumstances and the globally evolving systemic crisis, twin-deficits could be solved internally. Nevertheless, a lack of political consensus in the union, along with the accumulated, country-specific deficiencies and the deepening cross-regional disparities prove the opposite. Inadequacies of the less-developed states and an egoistic rationality of the more developed ones speak against it.

All these speak for the merciless determinism of European crisis and rationalize the neo-liberal corset-policy. However, what is rational for the members is not necessarily efficient for the union. It is truly very important to understand the true reasons of behaviour and the deeper causes of an incident, especially when we have to counteract.

The merciless determinism of provoked social disequilibriums forces us to think for alternatives. The true dilemma is not if a monetary expansion

has to be financed by the tax-payers of the wealthier member-countries, but if it could be realized on the costs of the accumulated capital in this country, which has to encounter losses in the relative value of exports and losses in its ability to acquire assets abroad. Insisting on the neo-liberal recipe led us to the deepening regional and social disparities. The true dilemma is if we can prescribe an alternative way-out with progressive policies and an applicable radicalism:

- ECB could act as a credible lender of last resort to relieve the sovereign debt crisis. Strict regulation of financial markets is a further step, and it is necessary to separate investment banking from commercial banking.
- In terms of fiscal policy, monetary policy should support and accommodate progressive fiscal rules aiming at employment creation and growth. Budget deficits can only be consolidated in a growing economy.
- Growth stimulating policies are consistent with the desired long run stabilization of debt-to-GDP ratios. In the present situation of mass unemployment, these policies do not carry a significant risk of inflation.
- The adjustment has to be supported by stimulation of consumption via higher wages starting from the core surplus countries (like Germany) where wage restraint policies have considerably contributed to the growing income inequalities and current account imbalances in the Eurozone. If the German finance minister believes in what he said, that no country can live forever beyond its means, then it must also be clear that no country can live indefinitely below its means.[17]

Although we see the bourgeois society on its last legs, the *"bishops"* of the market forces keep on preaching the automatic correction and the prospect of perpetual capitalist development. Surely they connive; some of them because they are trapped in their ideological paralysis, others simply because they consciously anticipate their apologetic role. The time has come to argue as courageously and open we can, without tending to meaningless generalizations and without being afraid of any antisystemic extensions of our deepest thoughts. The time has come to

[17] The specific points have being taken from a text with alternative policy proposals, signed by European economists during the working-group in Galway, 1–3 November 2012. See in http://nakedkeynesianism.blogspot.gr/2012/11/an-alternative-vision-for-eurozone.html.

question again the very basics of the standard economic theory and the prevailing ideology; to anticipate the modern reality of post-imperialistic, financialized capitalism, leaving aside our dogmatisms that have been covered by a scientific cloak of objectivity.

As we consider time in its historical rather than its biological-human dimension, fatefully, the moment of change is approaching. This is not simply a possibility, as it more and more becomes a historical necessity.

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# 4 How to Reform the Eurozone?

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## 4.1 Introduction

Roger Ailes, a former advisor to Ronald Regan, recalls in his book an intriguing practice of ancient Romans. When they finished building a bridge or an arch they placed the engineer in charge beneath the construction when the scaffolding was removed. If the edifice did not hold, he was the first to know. We do not follow such drastic practices these days in Europe, but the weakness of the EMU has been evident right from the start of the crisis. The pertinent issue is therefore how to reform the Eurozone to ensure the benefits of monetary integration to the citizens of Europe.

While economists disagree on the nature of the Eurozone weaknesses, most agree that the current EMU architecture neither provides sufficient incentives for curtailing excessive lending and indebtedness, nor secures the level of political integration necessary to attain a sufficient degree of accountability in fiscal affairs. Strengthening fiscal prudence is of utmost importance, but it has consistently collided with the enforceability problem of applying supra-national fiscal rules to sovereign member states. Because of the (yet) insufficient political integration and the resulting institutional set-up of the EMU a problem in one (small) country like Greece has a disproportionately huge impact on the stability of the whole EMU and the euro, as compared to the US where fiscal woes of even such big states as California don't wreck even a bit of such havoc.

Against this background, there is no shortage of suggestions on how to save the Eurozone both on the official and expert level. Unfortunately, the majority of these suggestions have one of the following flaws. Either they address the long-term challenges without dealing with the short-term stabilization problems or they address the short-term stabilization issues at the cost of the Eurozone's long-term sustainability. Importantly also, most reform proposals tend to focus mainly on economic solutions, whereas political incentives are usually taken as given or omitted. Most of them also treat the Eurozone as a monolithic political organism and give (too) little weight to the interactions between the center and the periphery of the Eurozone.

The aim of this chapter is two fold. First, we provide a short overview of the reforms proposals for the Eurozone put forward to date. Second, we present an alternative solution to reform the Eurozone. We argue, in particular, that the Eurozone should establish exit rules – a legal possibility of a formal exit from the Eurozone together with a detailed procedure of such exit. We discuss in details how such institutional solution would improve the functioning the Eurozone in the political economy context of the EU.

The chapter is structured as follows. The next section provides a short overview of official and unofficial reform proposals of the Eurozone. Section 4.3, page 92, presents the case of exit rules. Final section, page 96, concludes.

## 4.2 Reform Proposals for the Eurozone: An Overview

Various reform proposals have been emerging gradually as the process of reshaping the Eurozone continues in response to the bloc's difficulties connected with incorrectly designed institutions, fiscal profligacy, unhandled macroeconomic imbalances, neglected structural reforms and financial market shocks. Many reform proposals come from official bodies, but some of them are put forward by independent experts and have unofficial character. Some of the reform proposals comprise mainly measures aimed at short-term stability issues while other focus on ensuring long-term sustainability of the EMU and offer tools necessary to avoid future problems. While Table 6 (page 91) provides a broad summary of both official and unofficial reform proposals put forward (as of June

2013), in what follows we shall concentrate of those policies and proposals that are most vocally represented in the discussion.

A part of the official anti-crisis efforts and reform proposals were ideas and initiatives that led to more active role of the ECB and its response to financial market tensions, also through "non-standard" actions. The ECB reacted to the crisis by introduction of measures, which have been aimed directly at short-term stabilization of the situation in both financial system and real economy of the Eurozone. These measures included Covered Bond Purchase Programme (since July 2009), Securities Market Programme (since May 2010), Long-term Refinancing Operations (in December 2011 and February 2012) and Outright Monetary Transactions programme (the technical framework of these operations was formulated on 6 September 2012, but it has not been used so far). The aim of these measures was to improve liquidity and funding conditions for banks and governments of "peripheral" states of the Eurozone. Among others, they counteracted a bond market speculation problem connected with the fact that in the original EMU architecture there was no "government banker" to intervene in national bond markets (Palley, 2011).

Anti-crisis tools of the ECB are of conditional nature and can only be employed within the wider EMU framework. Namely, any use of the Outright Monetary Transactions programme has to be in accordance with the European Stability Mechanism (ESM). ESM was established on 27 September 2012 as a permanent firewall for the Eurozone to provide instant access to financial assistance programs for troubled EMU member states. ESM replaced two earlier temporary EU funding programmes: the European Financial Stability Facility and the European Financial Stabilisation Mechanism.

While ECB actions were intended to ease financial markets tensions, which were posing significant risks of imminent Eurozone break-up, the key part of EMU reform proposals address long-term challenges by reinforcing economic governance through improving policy coordination and increasing fiscal discipline. This part of reform efforts includes such elements as: "European Semester", euro plus pact, "six-pack", Treaty on Stability, Coordination and governance in the EMU (usually referred to as "fiscal compact") and "two-pack".

The "European Semester" started to operate in 2011 and it involves discussion on a wide EU-level not only about fiscal policy, but also macroeconomic imbalances, financial system issues and necessary structural reforms (European Commission, 2010).

Euro Plus Pact is a plan adopted in 2011, which came with four broad strategic goals: fostering competitiveness, fostering employment, contributing to the sustainability of public finances and reinforcing financial stability. The fifth issue touched in the Euro Plus Pact is tax policy coordination, but no specific commitments on this were made, other than to briefly outline that member states commit to engage in discussions about it.

"Six-pack" is a set of European legislative measures to reform the Stability and Growth Pact (SGP) and to introduce new macroeconomic surveillance. It entered into force on 13 December 2011 and comprises six regulations aim at strengthening the procedures for fiscal consolidation and counteracting macroeconomic imbalances. Four of the six instruments in the "six-pack" were designed carry out further reform of the SGP, focusing on improving the compliance part. The "six-pack" does not provides any fundamental changes to the SGP. It enforces budgetary discipline in the EMU by ensuring that the sanctions come into effect earlier and more consistently than before. The remaining two pieces of legislation in the "six-pack" constitutes the Macroeconomic Imbalance Procedure, which is an early warning system for excessive macroeconomic imbalances and a correction mechanism.

"Two-pack" is a set of two regulations proposed by the European Commission on 23 November 2011 in order to provide additional coordination and surveillance of budgetary processes for all EMU states. One regulation focuses on monitoring draft budgetary plans and it is aimed at enhancing the budgetary surveillance of the draft budgets by the European Commission and closer monitoring procedures to ensure the correction of excessive deficits. The other regulation focuses on strengthening surveillance procedures. It lays down a surveillance mechanism (with involvement of the ECB and European Supervisory Authorities) applicable to Eurozone countries experiencing or threatened with financial market tensions and/or receiving financial assistance (Mohl and van Riet, forthcoming).

"Six-pack" and "two-pack" are two reforms of the SGP, which are mirrored in the Treaty on Stability, Coordination and Governance in the EMU, particularly in its Title III including fiscal provisions (commonly referred to as "fiscal compact"). The "fiscal compact" includes such crucial fiscal provisions as (Mohl and van Riet, forthcoming):

- balanced budget rule including an automatic correction mechanism to be implemented in national law,

- strengthening of the excessive deficit procedure,
- the numerical benchmark for debt reduction for member states with government debt exceeding 60% of GDP,
- ex-ante reporting on public debt issuance plans.

Other most important official reform proposals include such elements as: Convergence and Competitiveness Instrument, Banking Union and Eurobonds.

Convergence and Competitiveness Instrument (CCI) is a recent proposal of the European Commission. The proposal is to create a special account within the EU budget intended to support the timely introduction of structural reforms. Use of this instrument would be strictly dependent on adherence to a formal agreement (between a Member State and the European Commission) for specified structural reform identified as needed. In practice, this would mean that timely implementation of reforms ensuring increased convergence and/or competitiveness would be rewarded by injection of funds from the CCI budget.

The widely debated EMU reform proposal is creation of a Banking Union. The first step towards the full Banking Union is a Single Supervision Mechanism (SSM) officially proposed by the European Commission on 12 September 2012. Further steps include components such as a single rulebook, common deposit protection and a single bank resolution mechanisms. The main reason for the idea of creating the Banking Union is to break negative feedback loops between individual Member State budgets and some of their banks. Furthermore, the Banking Union is intended to prevent financial institutions from increasingly focusing on their national home markets as it significantly undermines the single market for financial services and impairs the transmission of monetary policy impulses by the ECB into actual lending to the real economy. (European Commission, 2012)

A far-reaching component of EMU reform proposals is introduction of Eurobonds (also referred to as Stability Bonds). On 23 November 2011, the European Commission presented Green Paper on the feasibility of introducing Stability Bonds (European Commission, 2011). The document outlined different options for common debt issuance with a recommendation for the Commission to continue the political work for its further development. The introduction of Eurobonds is seen as the last final step on the path to create a genuine fiscal union, but this goal is achievable only in the long run, after strong budgetary governance and

a watertight system of monitoring and surveillance are in place in the EMU.

Apart from official reform proposals there is an extensive literature including ideas on how to reshape the EMU. One group of them offers and idea of fiscal watchdogs, i.e. national fiscal boards independent from government, which should produce macroeconomic forecasts to be used for planning budgets, ex-ante and ex-post assessment of meeting fiscal targets, evaluation of long-term sustainability of public finances, objective opinions on various policy initiatives and preparation of fiscal policy recommendations (Baldwin and Gros, 2010, Fatas and Mihov, 2010, Lane, 2010).

Other group of reform proposals offer a concept of fiscal rules, which would be one of long-term solutions to avoid sovereign debt crises in the future. Fiscal rules are usually defined as a kind of permanent constraint on fiscal policy. They can have different roles, goals and types (Darvas and Kostyleva, 2011). It is argued that apart from directly contributing to better fiscal outcomes, fiscal rules have their beneficial effect by reducing the market uncertainty of regarding fiscal parameters and thus they lower the sovereign credit risk (Iara and Wolff, 2010).

| | **Focus on short-term stabilization** | **Focus on long-term challenges** |
|---|---|---|
| **Official** | SMP<br>LTRO<br>OMT | European Semester<br>Six-pack<br>Two-pack<br>Fiscal compact<br>Banking union |
| **Unofficial** | European Monetary Fund<br>Eurobonds | Fiscal watchdogs<br>Fiscal rules |

**Table 6 Summary of Eurozone reform proposals**

Source: Own review.

An interesting proposal focused mainly on addressing short-term stabilization issues is the idea of setting up the European Monetary Fund, i.e. an independent institution to manage and finance assistance programmes for heavily indebted and troubles EMU countries (Gros and Mayer, 2010, Mayer, 2010). The authors of this concept consider a quick establishment of such a fund as necessary to facilitate the ongoing

processes of debt restructuring and in their opinion it could be achieved by employment of the enhanced cooperation clause, without politically complicated and problematic Treaty changes.

## 4.3 The Case for Exit Rules: An Alternative Solution to Reform the Eurozone

In the preceding section we have provided a short overview of various reform proposals put forward on the official and unofficial level and argues that the weakness of the majority of these proposals is that the either they address the long-term challenges without dealing with the short-term stabilization problems or that they address the short-term stabilization issues at the cost of the Eurozone's long-term sustainability.

In this section we argue that there is one solution that would address both short-term stabilization problems and long-term challenges, and would also provide added benefits. The Eurozone needs Treaty provisions on 'exit rules'. Not – we emphasize – because Greece or some other member state should be thrown out, but because such exit rules would strengthen the Eurozone. They will strengthen it through four channels: (i) improved external market discipline, (ii) strengthened internal macroeconomic discipline, (iii) increased enforcement power of the Eurozone over profligate members, and (iv) reduced uncertainty. As such, such exit rules would decrease (and not increase!) the probability of an exit, or the break-up of the Eurozone. Why?

The notion supported by EU officials and currently embedded in the EU legal framework that leaving the Eurozone is impossible may speak to political aspirations, but economically they are harmful. This has been a key source of the imbalances within the Eurozone and is now at the core of today's difficulties in resolving the crisis.

This is because such provisions are the legal equivalent of an implicit guarantee that member states will support each other to prevent an exit whatever the circumstances. This guarantee has given rise to a gigantic moral hazard, both for the markets and member states, and has allowed a small country like Greece to hold the entire Eurozone hostage. This guarantee has transcended the Eurozone's framework and is like a bomb with two fuses.

- At the economic end, because of the guarantee, markets have for many years been taking far too many risks by treating, for instance,

Greek and German bonds in essentially the same way. This has led to a reduction in market discipline, lower interest rates and has provided easy access to capital, which in turn has led countries like Greece to indulge in excessive fiscal spending. The resulting imbalances are now threatening the stability of the Eurozone.

- At the political end, the guarantee has shifted the political bargaining power to the profligate countries and given them leeway to pass part of their political and economic adjustment costs onto the rest of the Eurozone. Since the problems in Greece generate a negative externality for the other members, the Eurozone has little choice but to provide a bail-out. As a result, there is no credible enforcement mechanism. Greece has again failed to meet its fiscal targets and if the framework of the Eurozone does not change it will fail to deliver yet again.

A simple political-economy analysis shows that exit rules would quench the burning ends of the fuses and would provide additional benefits (Fahrholz and Wójcik, 2013).

- First, if exiting the Eurozone were openly allowed, the markets would have no choice but to price non-zero probability into their risk assessment and thus better differentiate – not only in crisis times, but also in good times – country risk among Eurozone sovereign bonds. External market discipline would intensify.
- Second, exit rules would increase the political bargaining position of Eurozone's center vis-à-vis the periphery profligate countries. Their power to enforce fiscal and structural reforms in the profligate countries would increase because the exit rules would become a bargaining chip in their negotiations with these countries. Their negotiation position and enforcement power would be increased.
- Third, exit rules would enhance domestic discipline because they would shift internal political economy incentives. They would in essence increase the perceived costs of leaving (now largely hidden) in relation to the short-term political costs of adjustment. Domestic discipline would be strengthened.
- Fourth, exit rules would decrease market uncertainty, which would support the political and economic adjustment process. At present, nobody knows what the legal procedure for leaving could be, what the costs would be, and how they would be distributed. Clarifying this would limit the scope for disruptive speculation with all

its detrimental effects on the real economy. Financial uncertainty would be mitigated.

| Key channels of exit rules | Key effects of exit rules |
|---|---|
| Decreased implicit guarantee | Strengthening pre-emptive, external market discipline |
| Increased political bargaining position of center vs. periphery | Bargaining chip of 'prudent' members supporting the no-bail out clause |
| Increased costs of leaving | Mitigating the likelihood of the occurrence of severe voter alienation in the course of fiscal consolidation |
| Decreased market uncertainly | Possibly lower volatility helps smooth political and economic adjustment process |

**Table 7 Summary of effects of exit rules**

Source: Own summary.

Obviously, one of the key issues is how to design the exit rules. Jacques Delors has proposed that "(. . . ) the new treaty should make it possible to kick a country out of the Eurozone if a majority of 75 percent are in favor". However, there is a wide range of possible solutions, from voluntary to obligatory and from automatic to discretionary rules (see Figure 9).

Yet, while the design of the rules is likely to shape the magnitude of outcomes, the direction of the effects of exit rules and how they would change the 'rules of the game' within the EMU is key.

Opponents of this solution may argue that merely initiating a discussion on exit rules would open up a Pandora's box at a moment when Europe is badly in need of stability. Quite the opposite is true. Opening up such discussions would help stabilize today's mess because Europe's laggards would receive the clear message that the world has changed and there is a limit to the Eurozone's willingness to pay for their negligence. The pressure to deliver would increase.

Some commentators may argue that there are no exit rules in the US monetary union, the blueprint for the Eurozone. Although true, such

view overlooks the unique nature of the Eurozone. It is a monetary union among sovereign states, and not a federal state with a common fiscal policy, like the US. While increasing European political integration might be a step in that direction, it is naïve to think that the Eurozone can make any substantial progress sufficiently quickly to avoid another blow somewhere in the near future. Europe is standing on the brink of a precipice between the undesirable now and the desirable future. It does

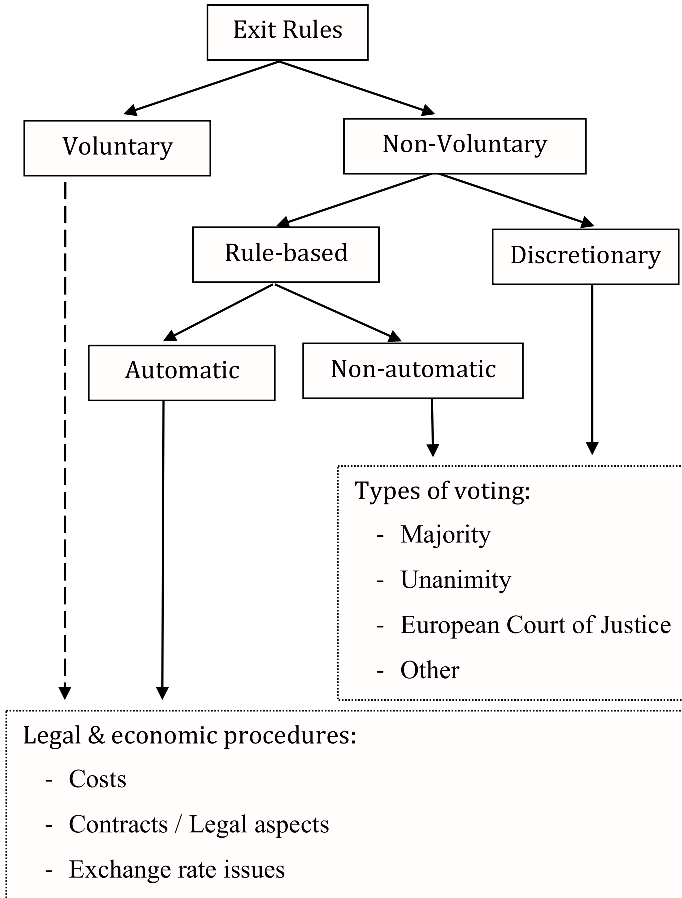


**Figure 9 A typology of exit rules**

Source: Own typology.

not want to move backwards, but going forward is risky – this is when creativity is needed.

Some may also worry that exit rules would run counter to the political ideal of creating an irrevocable monetary union as the basis for a political union. We share this ideal, but just the opposite is true. Paradoxically, exit rules would decrease (and not increase!) the probability of an exit, or the break-up of the Eurozone. This is because, as suggested above, spelling out the exit rules would give the Eurozone what it so badly needs, i.e. enhanced market discipline, stronger enforcement power of the Eurozone, more internal discipline in the profligate countries and reduced market uncertainty.

Evidence can be also found in political science and in the history of national states struggling with preserving their internal integration. Their experience suggests that when secession is not permitted, pressure for it rises. When secession is openly allowed many would-be secessionists cease to press so hard for it.

Exit rules would strengthen the Eurozone's cohesion and stability. They would address both the short-term and long-term challenges and their introduction is politically feasible. Europe needs such rules, and Europe needs them now.

## 4.4 Conclusions

In this chapter we have provided an overview of the ongoing discussion on how to reform the Eurozone. After review the debate we have suggested that the Eurozone should establish legal Treaty provisions on exit rules.

We have argued that such exit rules would strengthen the Eurozone through 4 channels: (i) improved external market discipline, (ii) strengthened internal macroeconomic discipline, (iii) increased enforcement power of the Eurozone over profligate members, and (iv) reduced uncertainty.

We have also argued that establishing such rules is politically and economically feasible and therefore that such rules should be considered in future discussions of the Eurozone architecture.

### Acknowledgements

The ideas presented in this chapter draw on our policy paper VoxEU.org (Fahrholz and Wójcik, 2011) and our theoretical paper on exit rules entitled Eurozone needs exit rules (Fahrholz and Wójcik, 2013).

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# II

# Dilemmas of Eurozone Reforms

# 5 National Debt Brakes as a Remedy for Diverging Economies in the European Monetary Union?

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## 5.1 Introduction[18]

This chapter examines if national debt brakes can prove effective in reducing current accounts imbalances in the European Monetary Union (EMU). In the wake of the euro crisis, EU leaders have implemented several reform measures to strengthen budgetary discipline in the EU by tightening the rules of the Stability and Growth Pact (SGP) as part of the Euro-Plus-Pact and introducing a new fiscal compact, the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG) (see EU-Memo/11/647, TSCG, 2012). While the revised version of the SGP already encourages the implementation of national fiscal rules such as the German debt brake, Article 3(2) of the TSCG obliges, at least, EMU member countries to implement a balanced-budget rule in national law. These reforms are driven by the perception that government profligacy is the main culprit of the current crisis. However, since the launch of the euro persistent current account imbalances have built up in the EMU (Colombier, 2011). From the theory of optimum currency areas one can infer that due to different national systems, e.g. labour market institutions, economic shocks such as the German Hartz-IV reforms have hit member countries of the EMU asymmetrically (De Grauwe, 2009b). In particular, a powerful adjustment mechanism such as a sufficient flexible and mobile labour market, to mitigate the effects of asymmetric shocks is absent in the EMU (Dullien and Schwarzer, 2009).[19] Consequently, the EMU is viewed as an incomplete currency union (De Grauwe, 2009a).

[18] Note that the view of the author does not necessarily reflect the official position of the Federal Finance Administration and the Federal Finance Department.

[19] Some Keynesian authors argue that fully downward flexibility of wages is not desirable because it bears the risk of prolonging and deepening a recession by exerting deflationary pressure (e.g. Greenwald and Stiglitz, 1993).

Furthermore, since wage policies are pursued nationally by independent social partners the only tool left to accommodate divergent economic developments is fiscal policy. Therefore, some economists argue that stronger coordination or centralisation of fiscal policies is needed to reduce macroeconomic divergences among EMU member states (Bofinger, 2003, Baldwin and Wyplosz, 2006, De Grauwe, 2009b, 2011). From this position, one can infer that the coordination failure of national economic policies in the EMU and not over-indebted EMU-countries lies at the heart of the EMU crisis. This seems to be supported by the fact that average government debt of the EMU only rose sharply from 70% of GDP in 2008 to 88% of GDP in 2011 in the aftermath of the financial crisis. This rise is mainly due to bank bail-outs and economic stimuli packages. In contrast, a slightly declining government debt-to-GDP ratio of EMU member states from 68% to 66% could be seen from 2002 to 2007.

One reason that so far exogenous shocks have not been absorbed sufficiently has been the rather pro-cyclical stance of national fiscal policies under the previous SGP (Dullien and Schwarzer, 2009). This confirms a critique of SGP which hints to the fact that on the one hand the 3%-deficit-limit can be too restrictive in a recession. On the other hand, the SGP offers no incentives for anti-cyclical fiscal policies during an upturn (e.g. Colombier, 2006). Therefore, Dullien and Schwarzer (2009) propose the implementation of automatic fiscal stabilisers at the European level.

Research findings show that in contrast to the SGP, debt brakes would allow for a better working of automatic stabilisers, in particular, in an economic upswing (Colombier, 2006, Hishow, 2011). Thus, debt brakes might render better coordination of policies and more political unification unnecessary. Therefore, this chapter raises the question whether the implementation of national debt brakes is an effective mean to fight off divergent economic developments in the EMU. For this, an empirical analysis is carried out that focuses on the impact of national fiscal policies on current-account balances in the EMU. Based on these estimations it is simulated how the implementation of the debt brake would have affected the development of the current account balances of a current-account deficit country, i.e. Spain, and current-surplus country, i.e. Germany, since the launch of the Euro. Results of this analysis suggest that the debt brake could contribute to reduce external deficits, but only under certain conditions. Therefore, European policy makers have to go beyond fiscal compacts to fix structural drawback of the EMU, i.e. the coordination failure, by, e.g., delegating more fiscal responsibilities to the EU level.

This chapter is organised as follows. In the following section, the German debt brake is delineated, which has served as a role model for the balanced-budget rule of the fiscal compact. Section 5.3, page 105, analyses the impact of fiscal policy under a debt brake on the balances of payment from a theoretical perspective. Section 5.4, page 108, provides empirical results about the impact of government action on current-account balances for the case of German. Section 5.5, page 112, presents simulations how an introduction of a German-style debt brake would have affected external balances in Germany and Spain. Finally, some conclusions are drawn in the closing part of this chapter (page 117).

## 5.2 The Debt Brake and External Imbalances from a Theoretical Perspective

Debt brakes are framed against the background of the (new) neo-classical synthesis (see Colombier, 2006, p. 529). The debt brake aims at stabilising nominal debt over the business cycle, but budget movements due to cyclical fluctuations should be allowed. According to neo-classical theory, fiscal policy can smooth the business cycle but is not able to enhance the long-run production possibilities of an economy. On the contrary, a too high debt-level may cause uncertainty among consumers and investors, which in turn causes interest rates to rise and as a result, crowd out private investment. Therefore, the structural government budget should be balanced over the business cycle under a debt brake. However, since the advent of new growth theory several studies show that certain kind of government spending such as educational or infrastructure expenditure can be growth-promoting (e.g. Colombier, 2009). To consider this possibility, the German debt break allows for a structural deficit of 0.35% of GDP at the federal level.[20] In contrast, the states (the *Länder*) are not allowed to run a structural deficit.[21] The overall limit of a structural budget deficit is in the spirit of the SGP, which foresees a

[20] In particular, the German Federal Ministry of Finance was very sceptical about a golden rule for public investment, which limits the structural deficit to the level of public investment (see Baumann et al., 2008, pp. 40–41). The Ministry emphasises that the former German golden rule was rather ineffective and that a suitable definition of public investments is elusive.

[21] Note that the German states should have their own debt brakes implemented by 2020. Apart from the binding constraint of a balanced structural budget the states have some leeway to formulate their debt-brake rules. In particular, the states can choose if their rule permits the budget to fluctuate with the business cycle. For a detailed overview see Deutsche Bundesbank (2011).

close-to-balance budget over the business cycle. According to the SGP, the structural budget deficit must not exceed 0.5% of GDP. The German debt brake is enshrined in the German constitution (see Art. 109(1) and 115 Grundgesetz).

Moreover, according to conventional wisdom discretionary fiscal policy suffers from the following shortcomings. First, due to the democratic decision process usually fiscal measure are implemented too late and may not be efficiently composed due to strong lobby groups. Second, incentives given to policy-makers or civil servants to, for instance, enlarge their influence and power lead to a deficit bias of the government sector. Nonetheless, to smooth the business cycle automatic stabilisers such as the unemployment insurance should be able to work. Since the beginning of 2011, the German debt brake has come into force at the federal level (see also Footnote 21). At the federal level, apart from a structural component the debt brake contains a cyclical component, which allows the automatic stabilisers to work. To give policy-makers limited flexibility the federal government can exempt from the rule under exceptional economic conditions such as a financial crisis or natural catastrophes. Along the lines of the SGP, financial transactions such as revenues for privatisation of public assets or loans to the unemployment insurance are excluded from the calculation of the deficit ceiling. A crucial part of the German debt brake is the control account. As the debt brake relies heavily on forecasts of government revenues deviations from the deficit ceiling e.g. due to forecast errors enter the control account. Only deviations, which are not due to the business cycle, are taken into account. Notable exceptions are revisions of GDP-forecasts, which generally do not enter the control account. This is done in order to make the debt brake more binding and to take account of unforeseeable financial needs. In particular, government practices that damage the rule, such as systematic error-prone budgeting should be avoided. At certain thresholds, the government is obliged to take action in order to reduce the deficit.[22]

The government budget identity in terms of GDP of a EMU country $j$ is as follows:

$$g_{y,j} + r_j b_j \equiv tr_{y,j} + \Delta b_j \qquad (1)$$

with: $g_{y,j}$ := ratio of public expenditure to GDP;

[22] If the deficit of the control account reaches 1.5% of GDP the government must reduce the deficit. Above 1.0% of GDP the government must reduce the deficit if the output gap is not negative, i.e. the economy is not in a downturn.

$tr_{y,j}$ := ratio of public revenues to GDP;

$b_j$ := ratio of outstanding stock of government debt to GDP;

$\Delta b_j$ := new bonds issued in the current period in terms of GDP.

As EMU member states cannot fund their expenditure by printing new high-powered money, public expenditure can only be financed by tax revenues or issuing bonds. Under the debt brake a limit is placed on the issuing of new bonds. This deficit ceiling can be written as follows:[23]

$$\Delta b_{c,j} \leq \sigma_j - \varepsilon_j (y_j - y_j^*)/y_j^* \leq 0.03 \cdot y_j \tag{2}$$

with: $y_j^*$ := potential GDP of EMU member country $j$;

$(y_j - y_j^*)/y_j^*$ := output gap of EMU member country $j$;

$\varepsilon_j$ := budget sensitivity with respect to a 1%-change of the output gap;

$\sigma_j$ := structural deficit limit, Germany 0.35% of GDP (Spain 0.4% of GDP)[24].

The deficit ceiling ($\Delta b_{c,j}$) is calculated as the sum of a cyclical component (second term on the rhs of Equation (2)) and a structural component (first term on the rhs of Equation (2)) of the government budget. To calculate the cyclical component of the government budget the so-called budget sensitivity ($\varepsilon_j$) with respect to changes of the output gap is applied. The budget sensitivity comprises the short-term income elasticities of those revenue and expenditure items, which fluctuate with the business cycle. In the German debt-brake framework, these are income and consumption taxes as well as social contributions and expenditure for labour-market measures. Equation (2) shows that the government is allowed to exceed the structural deficit limit if the economy is in a recession (negative output gap) and vice versa (positive output gap). In addition, the headline deficit should meet the deficit criterion of the SGP, which limits the headline deficit to three percent of GDP. Over the cycle, the cyclical-adjusted budget must not exceed the structural deficit limit ($\sigma_j$) of the debt brake:

$$g_{y,j}^* + r_j b_j - tr_{y,j}^* \leq \sigma_j \tag{3}$$

[23] In the case of the German debt brake an output gap, which is calculated by the European Commission (COM), is applied. For this calculation the COM uses a production-function method (Denis et al., 2006).

[24] A cap of 0.4% of GDP is intended to be set for the structural budget balance in Spain from 2020 (Economist, September 3rd 2011).

with: $g^{*}_{y,j}$ := cyclical-adjusted public expenditure excluding financial transactions such as loans to the unemployment insurance.

$tr^{*}_{y,j}$ := cyclical-adjusted public revenues excluding financial transactions such as revenues from privatisation of public assets.

## 5.3 Impact of Debt Brakes on External Balances

Assuming a New-Keynesian model of an open economy it can be shown that a debt brake can be conducive to a coherent development in a currency union such as the EMU under certain conditions (Carlin and Soskice, 2006). To provide an intuition about the impact of the debt brake on external balances a sketch of such a model is given below.[25]

In such a model an independent central bank, e.g. the ECB, pursues the single goal of union-wide price stability. In order to reach price stability the ECB sets a union-wide nominal interest rate ($i$) based on a Taylor rule. Market actors make adaptive expectations on union-wide inflation rate ($\pi$) and the inflation rate of a EMU member country $j$ ($\pi_j$).[26] For simplicity it is further assumed that the inflation rate expected for the next period corresponds to the current inflation rate. In the model a stabilising real interest rate ($r^s$) is presupposed at which the domestic labour and goods markets of each EMU member are in an equilibrium. In this case, an overall equilibrium in the currency union is reached. Although a union-wide equilibrium means that current-account balances are stabilised, a settlement of these balances is only achieve by chance.[27] The above assumptions lead to the following equivalent equations for the union-wide nominal ($i$) and real interest rate ($r$):

$$i = r^s + \pi + (\pi - \pi^T) \tag{4a}$$

$$r = r^s + (\pi - \pi^T) \tag{4b}$$

[25] For a more detailed account see Colombier (2013).

[26] Usually rational expectations are assumed. But given the fact that even professional forecasters cannot agree on a common economic model, which is prerequisite for the proper working of rational expectations, and the economy is an evolutionary system, adaptive expectation would appear to be more realistic. This is supported by insights from behavioural economics. These results show that the more complex it gets to make a decision the more likely it is that individuals resort to simple decision-rules like rules of thumps. Thus, more often than not individuals tend to extrapolate from the past to foresee future developments (see Kahnemann, 2003, p. 1460).

[27] Note that no distinction between the trade and current-account balance is made in the model.

If the inflation rates of EMU member states correspond to the union-wide inflation rate ($\pi$) and the ECB manages to stabilise the union-wide inflation rate at its inflation target ($\pi^T$), i.e. at maximum 2%, the real interest rate ($r$) would be equal to the stabilising interest rate ($r^s$). However, different individual inflation rates ($\pi_j$) lead to spreads between real interest rates ($r_j$) of EMU member countries.[28]

$$r_j = i - \pi_j \tag{5a}$$

If the nominal interest rate, $i$, in Equation (5a) is substituted with the right-hand side of Equation (4a), one arrives at the following formula:

$$r_j = r^s + (\pi - \pi^T) + (\pi - \pi_j) \tag{5b}$$

Equation (5b) shows that two conditions must be met to reach an overall equilibrium in the EMU, i.e. a domestic (medium-term-) market equilibrium in each EMU-country. First, the union-wide inflation rate ($\pi$) should correspond to the inflation target of the ECB ($\pi = \pi^T$). But to reach a domestic market equilibrium in each EMU member country all individual inflation rates ($\pi_j$) should be tantamount to the union-wide inflation rate ($\pi$) ($\pi = \pi_j$). However, as conditions of labour and product markets can differ substantially between EMU member states nothing guarantees that the second condition is met. This demonstrates that even if the ECB manages to keep the union-wide inflation rate at the target level the ECB cannot steer individual inflation rates. Consequently, a common monetary policy cannot even stabilise, let alone reduce, current-account balances. As labour markets in the EMU do not provide sufficient flexibility and mobility to compensate for possibly asymmetric shocks on EMU member countries the only instrument left to accommodate these shocks is fiscal policy (see Section 5.1, p. 100).[29] Fiscal policy of member countries can contribute to a convergent economic development by stabilising the economy. This can enhance the chances that individual inflation rates and the union-wide inflation rate correspond.

To make the analysis simple, it is assumed that the ECB manages to keep the union-wide inflation rate close to its target level, i.e. $\pi \approx \pi^T$, so

[28] Note that for simplification risk premiums are not taken into account.

[29] As the experiences of the crisis-ridden countries such as Spain, Portugal or Ireland show, it may also not desirable to have a fully flexible labour market as an internal devaluation through cutting wages are quite costly in terms of unemployment. Moreover, as already emphasised in Footnote 19, page 100, downward flexibility of wages runs the risk of plunging an economy into a deflation.

that the second term on the right-hand side of Equation (5b) is approximately zero. Given that the cyclically adjusted government budget is balanced, a debt-brake allows, in principle, automatic stabilisers to work without interference of discretionary fiscal policy.[30] This can help to absorb asymmetric shocks under certain conditions. For example, if the economy of a current-account deficit country such as Spain is booming, automatic stabilisers act counter-cyclically and thus keep the Spanish inflation rate closer to the union-wide inflation rate. All things being equal, the latter would counteract diverging economic developments in the EMU as the spread of the Spanish real interest rate and the union-wide real interest rate would be reduced (see Equation (5b)). As a result, the loss of competitiveness would be mitigated and the corresponding current-account deficit lower than without the working of automatic stabilisers. Now assume, that Spain as a current-account deficit country moves into a recession. This means c.p. having lower inflation in this country than in the currency union, which causes an increase in Spanish competitiveness through internal devaluation. Moreover, the real interest rate for Spain would be higher than the stabilising real interest rate (see Equation (5b)). This brings about a convergent development in the EMU because the current-account deficit of Span is reduced. But in this case the convergence is slowed down by automatic stabilisers because the stabilisers counteract the disinflationary tendency and the widening interest-rate spread. For a current-account surplus country the situation is reversed. While automatic stabilisers slow down the reduction of the external surplus in an upturn, they decelerate the widening of the external surplus in a downturn. To sum up, according to theory a debt-brake coherent fiscal policy can slow down a diverging economic development in a currency union by giving automatic stabilisers room to manoeuvre. But this is tied to certain conditions.

Additionally, a debt brake could serve as a preventive measure against rising external imbalances in a currency union. Suppose that the economy of a EMU country runs a current-account deficit and the economy is in a boom phase. Furthermore, the cyclically adjusted government budget is balanced. In general, governments have an incentive to increase public expenditure to enhance their chances to be re-elected. This is particular true in a booming economy. Consequently, the government of a booming EMU country may increase public outlays, which would

[30] Nevertheless, to what extent automatic stabilisers can actually act under a debt brake depends on the method chosen to divide GDP into a cyclical and structural component and is open to debate (see e.g. Colombier, 2006, pp. 526–528).

give a boost to aggregate demand. Therefore, both domestic demand and the current-account deficit grow. If a government adheres to a debt-brake rule public expenditure cannot be increased without raising taxes. However, the latter can be costly for a government because it can spoil the chances to stay in office and may produce output losses. Therefore, incentives to increase public expenditure in good times would be much reduced under a debt brake.

## 5.4 Fiscal Policy and Net Exports – Empirical Results

This part presents the findings of the estimations of the short- and long-term impact of government activity on external balances for Germany, represented by net exports, from 1970 to 2008.[31] The regressions are based on the New Keynesian model of an open economy outlined in Section 5.3, page 105 (Carlin and Soskice, 2006, Colombier, 2013). Deviating from a standard New Keynesian model, I assume that productive public expenditure affects external balances through the supply-side of a national economy. Empirical studies provide solid evidence for a growth-enhancing impact of these public-expenditure items (e.g. Nijkamp and Poot, 2004). These include public expenditure on education and transport and communication infrastructure. Moreover, it is estimated how non-productive primary public expenditure and taxes affect net exports. The fiscal variables are expressed as ratios to GDP so that the tax-to-GDP ratio can be viewed as a proxy for the average tax rate. The real effective exchange rate of Germany, which is based on unit labour costs, the real long-term interest rate of Germany and the GDP aggregated over the second to fourth largest economies of the EMU, which are France, Italy and Spain, enter the regressions as control variables. The aggregated GDP of France, Italy and Spain serves as a proxy for foreign demand for German products. The coefficients of the estimations shown in Tables 8 to 10 can be interpreted as elasticity of net exports with respect to the corresponding independent variable.

Overall, the estimations show that foreign demand proves beneficial to net exports in the long-term (see Table 8). The coefficient is rather stable and the elasticity amounts to well-above 0.5.

The empirical analysis provides rather robust evidence that an increase of the real exchange rate, i.e. improved competitiveness, promotes net ex-

[31] For a more detailed account of the empirical approach see Appendix, page 119.

| Variable | lags | Estimated model | | | | | | | lags | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Export-to-import ratio | $t$–1 | 0.45*** | 0.61*** | 0.23 | 0.22 | 0.62*** | 0.56*** | 0.71*** | $t$–1 | 0.45*** | 0.35*** |
| | | (0.11) | (0.17) | (0.19) | (0.20) | (0.20) | (0.18) | (0.23) | | (0.12) | (0.12) |
| Real GDP EA3[a] | $t$, $t$–1 | 0.45*** | 0.57*** | 0.52** | 0.52** | 0.65** | 0.53*** | 0.55** | $t$ | 0.40*** | 0.43*** |
| | | (0.10) | (0.16) | (0.19) | (0.19) | (0.23) | (0.16) | (0.22) | | (0.10) | (0.08) |
| Productive public expenditure[b] | $t$, $t$–1 | 0.28** | 0.46** | 0.08 | 0.21 | 0.51** | 0.41** | 0.47** | $t$ | 0.28*** | 0.24** |
| | | (0.10) | (0.18) | (0.17) | (0.16) | (0.22) | (0.19) | (0.21) | | (0.10) | (0.10) |
| Non-productive primary public exp.[c] | $t$ | –0.04 | –0.02 | | | | –0.01 | | $t$ | –0.18 | |
| | | (0.14) | (0.12) | | | | (0.13) | | | (0.13) | |
| Tax revenues | $t$, $t$–1 | | | –1.17* | –1.22* | –0.15 | | 0.11 | $t$ | | –0.66** |
| | | | | (0.66) | (0.67) | (0.65) | | (0.75) | | | (0.30) |
| Purified real exchange rate | $t$ | 0.30*** | | | 0.51*** | | 0.15 | 0.11 | $t$ | 0.38*** | 0.43*** |
| | | (0.11) | | | (0.17) | | (0.20) | (0.24) | | (0.10) | (0.10) |
| Real long-term interest rate | $t$ | | 0.02 | | | 0.02*** | 0.02*** | 0.02*** | $t$ | | |
| | | | (0.02) | | | (0.007) | (0.007) | (0.007) | | | |
| Adj. $R^2$ (as %) | | 64.5 | 79.4 | 75.3 | 75.7 | 78.5 | 78.8 | 54.8 | | 67.1 | 73.5 |
| Bounds F-test | | 10.1*** | 5.56** | 6.34** | 7.11*** | 5.98** | 5.00** | 5.28** | | 10.1*** | 7.11*** |
| Box-Ljung test | | 12.8 | 12.7 | 17.0 | 17.4 | 13.3 | 11.1 | 5.99 | | 13.8 | 18.3 |
| Normality test | | 0.80*** | 0.95 | 0.89*** | 0.90*** | 0.97 | 0.95 | 0.84*** | | 0.82*** | 0.84*** |
| Ramsey reset test | | 0.40 | 0.72 | 0.52 | 0.55 | 0.56 | 0.62 | 1.11 | | 0.70 | 0.31 |
| BIC | | –76.8 | –91.6 | –84.9 | –85.4 | –88.7 | –89.0 | –66.9 | | –84.7 | –90.7 |

**Table 8 Cointegration test (Bounds test) and long-run model – Germany**

Notes: *** := 1% significance level; ** := 5% significance level; * := 10% significance level; all variables in logarithms; robust MM-estimator applied to regressions (Yohai et al., 1991); $t$-tests: figures in parentheses are standard errors; Bounds $F$-test with OLS (Pesaran et al., 2001): $H_0$: no cointegration, critical values for small samples from Narayan (2005); Box-Ljung test: $H_0$: no autocorrelation of residuals, Box-Ljung statistic; Shapiro-Wilk normality test: $H_0$: Gaussian distribution, $W$-test statistic; Ramsey reset test: $H_0$: no misspecification, $F$-test statistic; BIC := Bayesian information criterion.

If Box-Ljung tests indicates autocorrelation at at minimum 10%-significance level, HAC standard errors by Andrews (1991) are applied.

[a]EA3 := France, Italy and Spain; [b]Sum of education and transport expenditure; [c]Total primary public expenditure minus productive public expenditure.

Source: Author.

| Variable | Instruments | Spearman rank correlation (as %) | Estimated model | |
|---|---|---|---|---|
| **Export-to-import ratio (*t*–1)** | lag (*t*–2) | 73 | 0.38*** (0.10) | 0.35*** (0.11)) |
| **Real GDP EA3[a] (*t*–1)** | none | | 0.48*** (0.06) | 0.45*** (0.07) |
| **Productive public expenditure[b] (*t*)** | lag (*t*–1) | 79 | 0.35*** (0.09) | 0.30*** (0.09) |
| **Non-productive primary public exp. [c]** | lag (*t*–1), lag (*t*–2) | 58 | –0.06 (0.23) | |
| **Tax revenues (*t*)** | lag (*t*–1) | 74 | | 0.29 (0.47) |
| **Purified real exchange rate (*t*)** | lag (*t*–1), lag (*t*–2) | 61 | 0.40** (0.15) | 0.36** (0.15) |
| **Real long-term interest rate (*t*)** | lag (*t*–1), lag (*t*–2) | 74 | 0.03** (0.01) | 0.03*** (0.008) |
| **Adj. $R^2$ (as %)** | | | 60.3 | 61.3 |
| **Sargan test** | | | –15.3 | –13.8 |
| **Box-Ljung test** | | | 3.50* | 3.85* |
| **Normality test** | | | 0.86*** | 0.87*** |
| **Ramsey reset test** | | | 0.65 | 0.96 |
| **BIC** | | | –67.8 | –68.4 |

**Table 9 Instrumented regressions long-run model – Germany**

Notes: See notes Table 8; Sargan's test on validity of instruments: Chi-square test statistic, $H_0$: valid instruments.
[a]EA3 := France, Italy and Spain.
[b]Sum of education and transport expenditure.
[c]Total primary public expenditure minus productive public expenditure.

Source: Author.

ports. Although the estimations show positive statistically significantly coefficients of the long-run interest rate, which is counterintuitive, the size of the coefficients imply a negligible impact on net exports. Concerning fiscal variables, the estimations provide robust evidence for a positive relationship between productive public expenditure and net exports. No statistically significant relationship is obtained for primary public expenditure, which is in line with theory. The evidence relating to the tax ratio points to an adverse impact on net exports as is expected. But the evidence is weaker than for productive public expenditure. The long-term elasticity of the tax ratio emerges as highly statistically significant at a 5% level only in a single regression. At least, in two out of five estimations the coefficient of the tax ratio is weakly statistically significant (10%-level).

To consider a possible endogeneity bias instrumented regressions are performed. However, in a small sample instrumented regressions can be biased themselves. Therefore, one has to be cautious by interpreting the results of these regressions. Nonetheless, with the exception of the tax ratio, the instrumented regressions would appear to confirm the results of the first regressions (see Table 9). In contrast, the coefficient of the tax ratio shows neither the expected sign nor statistical significance. This can be due to the small-sample bias mentioned above.

The estimations of the short-term elasticities of fiscal variables provide evidence for a short-term impact of the tax ratio on net exports (see Table 10). Nonetheless, since growth dynamics have been driven by exports over the last decade in Germany, this result may also be due to reversed causality. Only in a single regression the short-term elasticity of non-productive primary public expenditure is weakly statistically significant and shows a negative sign. Yet, the latter is in line with the prediction of the underlying theoretical model (Colombier, 2013).

Overall, the empirical analysis of the German case suggests that, in particular, productive public expenditure can prove beneficial to net exports. The results show that if the government raises taxes not only do net exports increase in the short-term, but they also shrink in the long-term. Even so, one should note that the evidence is not so stable in the long-term. Although the empirical evidence concerning the short-term impact of non-productive primary public expenditure is weak, the results imply the possibility that these public expenditure items put a drag on net exports as is predicted by macroeconomic theory.

| Variable First differences | lags | Short-term part | | | |
|---|---|---|---|---|---|
| **Export-to-import ratio** | t–1 | –0.22 (0.18) | –0.001 (0.24) | 0.14 (0.22) | 0.12 (0.22) |
| **Real GDP EA3**[a] | t–1 | –0.84 (0.55) | –0.51 (0.71) | –0.71 (0.60) | –0.79 (0.65) |
| **Productive public expenditure**[b] | t–1 | –0.04 (0.10) | –0.02 (0.16) | –0.005 (0.11) | –0.03 (0.13) |
| **Non-prod. primary public expenditure**[c] | t–1 | –0.34* (0.19) | 0.20 (0.24) | | |
| **Tax revenues** | | | | 1.19* (0.61) | 1.25** (0.57) |
| **Purified real exchange rate** | t–1 | 0.75*** (0.20) | | 0.34 (0.24) | |
| **Real long-term interest rate** | t–1 | | –0.004 (0.01) | | 0.0 (0.01) |
| **Error correction term** | t–1 | –0.58** (1.54) | –0.61** (0.24) | –0.81** (0.30) | –0.55** (0.24) |
| **Adj. $R^2$ (as %)** | | 66.8 | 46.0 | 66.2 | 57.1 |
| **Box-Ljung test** | | 19.5 | 18.3 | 22.7* | 12.9 |
| **Normality test** | | 0.95 | 0.97 | 0.98 | 0.98 |
| **Ramsey reset test** | | 0.64 | 0.47 | 3.01 | 0.56 |
| **BIC** | | –82.8 | –72.0 | –82.4 | –78.2 |

**Table 10 Short-term impact – Germany**

Notes: See notes Table 8, page 109; note that OLS-estimator is applied to Bounds-test approach.

[a]EA3 := France, Italy and Spain.

[b]Sum of education and transport expenditure.

[c]Total primary public expenditure minus productive public expenditure.

Source: Author.

## 5.5 Ex-post Simulations of Debt-brake-coherent Budget Balances

In the following, government deficits ceilings of Germany and Spain that are based on a German-type debt brake are calculated for the pre-crisis period from 2002 to 2007. For the simulation of debt-brake-coherent deficit ceilings I assume that forecasts of GDP and government budgets had not suffered from forecast errors since the launch of the common currency in the EMU. In Tables 11 and 12 actual government deficits ($\Delta b$) of Germany and Spain are compared with the deficit ceilings under the debt brake ($\Delta b_c$).

| Year | $\Delta b$ | $\Delta b_c$ $\sigma = 0.35$ | $-\varepsilon$ * output gap $\varepsilon = 0.51$ | $\Delta b_c - \Delta b$ |
|---|---|---|---|---|
| 2002 | 3.85 | 0.35 | 0.00 | −3.50 |
| 2003 | 4.15 | 1.20 | 0.85 | −2.95 |
| 2004 | 3.76 | 1.24 | 0.89 | −2.52 |
| 2005 | 3.32 | 1.48 | 1.13 | −1.85 |
| 2006 | 1.64 | 0.28 | −0.07 | −1.36 |
| 2007 | −0.24 | −0.71 | −1.06 | −0.47 |

**Table 11 Ex-post deficit ceilings under the debt brake – Germany (as % of GDP)**

Notes: Red figures indicate breach of debt brake.
$\Delta b > 0 :=$ deficit and vice versa.
For budget sensitivity see Girouard and André (2005).

Source: Author.

| Year | $\Delta b^a$ | $\Delta b_c$ $\sigma = 0.4$ | $-\varepsilon$ * output gap $\varepsilon = 0.44^c$ | $\Delta b_c - \Delta b$ |
|---|---|---|---|---|
| 2002 | 0.21 | −1.18 | −1.58 | −1.40 |
| 2003 | 0.35 | −0.69 | −1.09 | −1.04 |
| 2004 | 0.11 | −0.61 | −1.01 | −0.72 |
| 2005 | −1.27 | −0.84 | −1.24 | 0.43 |
| 2006 | −2.37 | −1.55 | −1.95 | 0.82 |
| 2007 | −1.92 | −1.66 | −2.06 | 0.26 |

**Table 12 Ex-post deficit ceilings under the debt brake – Spain (as % of GDP)**

Notes: Red figures indicate breach of debt brake.
$\Delta b > 0 :=$ deficit and vice versa.
For budget sensitivity see Girouard and André (2005).

Source: Author.

Tables 11 and 12 report also the cyclical component of the public deficit under the debt brake ($-\varepsilon *$ output gap) and the reduction of the deficit ($\Delta b_c - \Delta b$) that would have been necessary to abide by the debt-brake rule. What is striking is that Germany breached the rule in each year. In contrast, the Spanish budget was in line with a debt brake in the period from 2005 to 2007. As a result, an implementation of the debt brake in 2002 would have lowered the debt-to-GDP ratio in Spain only slightly by 1.6%. In contrast, the impact of the debt brake on Germany's debt ratio would have been substantial. The debt brake would have reduced

the German debt by about 13% of GDP. Although these are only rough calculations, it clearly shows that current economic difficulties of Spain are not caused by government profligacy but by the indebtedness of the private sector and banks, which have been spurred by the housing boom in Spain. Moreover, if one defines fiscal sustainability as abiding by the debt-brake rule Spain outperforms Germany in the pre-crisis period. Thus, a debt brake would have not contributed much to sustaining public finances in Spain. Therefore, it is all the more important to examine if under a debt brake the divergent economic developments would have been reduced.

In order to provide an answer, I run a few simple simulations for the pre-crisis period from 2002 to 2007. The simulations are based on the results of the empirical analysis for Germany (see Section 5.3, page 105). It is assumed that the debt brake would have been introduced in 2002. For the simulations the median of the statistically significant elasticities is used (see Table 13). To account for stochastic uncertainty of the estimations the lower- and upper-bound elasticities of the confidence intervals are also applied to the simulations. Two different types of simulations are run.

First, it is analysed how the need to adjust the structural budget balance under the provisions of the debt brake affects external balances (structural adjustment) (see Table 14). I assume that either tax rates or productive public expenditure are adjusted to abide by the debt brake.[32] As the empirical analysis provides no evidence for a long-term impact of non-productive expenditure on external balances, these expenditure items are not taken into account. Furthermore, the simulations take into account that a variation of the tax rate may exert a short and long-term effect on the economy. The procedure of these simulations is as follows. At first, the impact of the structural adjustments on net exports is calculated by applying the corresponding elasticities (see Table 14). Then, the historical change in net exports is corrected by the afore-mentioned impact of the structural adjustment.

Second, the impact of automatic stabilisers on net export is simulated. The automatic stabilisers, which are included in the simulations, encom-

[32] Note that I carry out the simulations under the assumption that an increase of tax rates brings about rising revenues in the long run. Thus, a tax increase causes a less than proportional decrease in GDP. How the GDP is affected by a tax increase depends on a number of factors such as what type of tax is increased, the initial composition of taxes and the initial tax ratio. A detailed account of these tax effects goes beyond the scope of this analysis.

| Dependent variable[a,b] | Variable | Elasticity | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | Long-term | | | Short-term | | | Girouard/André (2005) | |
| | | Min | Med | Max | Min | Med | Max | Germany | Spain |
| Net exports | Tax ratio | −0.03 | −1.21 | −2.39 | 0.12 | 1.29 | 2.47 | | |
| Net exports | Productive public expenditure | 0.03 | 0.50 | 0.97 | | | | | |
| Net exports | Non-prod. primary public expenditure | | | | −0.01 | −0.34 | −0.67 | | |
| Tax revenues | | | | | | | | | |
| Personal tax[d] | Output gap | | | | | | | 1.61 | 1.92 |
| Indirect tax | Output gap | | | | | | | 1.00 | 1.00 |
| Primary public current expenditure | Unemployment gap[c] | | | | | | | −0.18 | −0.15 |

**Table 13 Instrumented regressions long-run model – Germany**

Notes: Elasticity: min := lower-bound value of the confidence interval of a statistically significant coefficient (see Table 8, p. 109); max := upper-bound value of the confidence interval; med := median of statistically significant coefficients (see Tab. 8). [a]Elasticity of net exports are taken from the estimations for Germany. [b]For elasticity of tax revenues and current primary public expenditure see Girouard and André (2005, p. 22). [c]Gap between the structural unemployment rate and the unemployment rate (see Girouard and André, 2005, p. 7). [d]For simplification the elasticity of corporate taxes is not taken into account. As the elasticity of the corporate tax with respect to the output gap is lower than for a personal tax (Germany: 1.53, Spain 1.15), the results for the personal tax shown in Table 14 may be slightly overstated.

Source: Author.

| Variable | Net exports 2007 | Net exports simulated 2007 | | | | | |
|---|---|---|---|---|---|---|---|
| | | Structural adjustment | | | Automatic stabiliser | | |
| | | Min | Med | Max | Min | Med | Max |
| ***Germany*** | 7% | | | | | | |
| **Tax ratio** | | 7% | 4% | 1% | 7% | 7% | 6% |
| **Prod. publ. exp.** | | 8% | 12% | 2% | | | |
| **Primary publ. current exp.** | | | | | 7% | 7% | 7% |
| ***Spain***[a] | −7% | | | | | | |
| **Tax ratio** | | −7% | −7% | −7% | −5% | −2% | 1% |
| **Primary publ. current exp.** | | | | | −7% | −7% | −7% |

**Table 14 Simulating the impact of fiscal policy under a debt-brake rule on net exports for the period 2002–2007 (as % of GDP)**

Notes: See notes Table 13.
[a]Data for productive public expenditure have not been available.

Source: Author.

pass tax revenues and primary public current expenditure.[33] In these simulations it is assumed that the structural budget balance of the government is in line with the debt brake. Moreover, to isolate the impact of automatic stabilisers on net exports I assume that the economy fluctuates around a stationary equilibrium. The impact of automatic stabilisers is simulated by using the estimates of the short-term elasticities of fiscal variables and by taking the sensitivity of these fiscal variables with respect to business-cycle fluctuations into account (see Table 13).

The simulations show that the introduction of the debt brake in Germany in 2002 would have brought about a reduction of German net exports if the German government had increased taxes to adjust the structural budget balance (see Table 14). This finding presupposes that the absolute value of the tax-rate elasticity is well-above zero (see Table 13). The results are inconclusive with respect to a cut in productive public expenditure because two opposing effects are at work. To be debt-brake coherent the German government had to reduce productive public expenditure by 3.5% of GDP in 2002. As a result, German competitiveness and net exports would have been lowered (see Table 14). But in the fol-

[33] Note that primary public current expenditure, i.e. expenditure without investment spending, do not exactly correspond to non-productive primary public expenditure, which is used in the empirical part of this chapter (see Section 5.4, page 108). But due to limited data availability for the Spanish case primary public current expenditure are applied to the simulations as a proxy for non-productive primary public expenditure.

lowing years it would have been possible to increase productive public expenditure under a debt break so that the first impact would have been compensated to some extent. Therefore, net exports are related to productive public expenditure in a non-linear way. In contrast, a structural adjustment of the Spanish budget through a tax increase would have barely affected net exports.

The simulations for automatic stabilisers suggest that the counter-cyclical fluctuations of primary public current expenditure items does not affect Spanish net exports. In contrast, evidence is provided that tax revenues could have considerably contributed to a shrinking of the Spanish trade deficit. This is caused by the fact that due to the debt brake Spanish fiscal policy had been forced to be more restrictive in the boom phase. In contrast, automatic stabilisers would have had almost no impact on the German trade balance. This finding comes as no surprise because Germany experienced a complete business cycle between 2002 and 2007. In addition, one should bear in mind that these simulations are carried out under the assumption of a stationary economy. Nevertheless, the simulations also suggests that a sufficiently high sensitivity of net exports with respect to taxes would have allowed for small adverse effects. Overall, the results concerning tax revenues meet expectations from theory (see Section 5.3, page 105). Thus, the working of this automatic stabiliser appears to prove beneficial in terms of reducing external imbalances under certain conditions. Contrary to tax revenues primary public current expenditure do not seem to affect net exports considerably. Moreover, the structural adjustments needed under a debt brake might support a convergent development in a currency union as is shown for the German case. However as, in particular, the findings for the Spanish case demonstrate, this result also seems to be sensitive to the idiosyncratic nature of the economic situation.

## 5.6 Conclusions

This chapter shows that a debt-brake can contribute to a convergent economic development in a currency union, but only under special conditions. In particular, a debt-brake considerably reduces the incentives for a pro-cyclical fiscal policy in an upswing. Consequently, automatic stabilisers can work properly and, on top of this, decelerate a growing current-account deficit in a booming economy, such as was the case in Spain before the crisis. In addition, the debt brake limits the freedom of

policy-maker to implement pro-cyclical fiscal-policy measures. A slowing down of the economy in Spain might have also slowed down the accumulation of private debt, which may have put Spain in a better position to come to terms with the crisis. This is a clearly defined case, under which the debt brake can prove beneficial to reduce divergent economic developments in a currency union. But overall, the present simulations for Germany and Spain show that the way the debt brake affects external balances depends on various factors, in particular, the position in the business cycle, the sign of the current-account balance and the instruments chosen by governments to adjust the structural budget balance. Thus, from this present analysis one can infer that the impact of national debt brakes on current-account balances is limited.

Additionally, the simulation exercise carried out in this chapter shows that Spanish public finances were sustainable in the pre-crisis years, whereas Germany's public finances were not. This finding clearly supports the view held by some economists such as De Grauwe (2011) that it is the coordination failure in the EMU and not government profligacy, which is key to resolving the current economic crisis of the EMU.

From the results of this present analysis two crucial policy conclusions can be drawn. First, the fiscal compact that contains the debt brake as a key component will not suffice to align EMU economies and even cannot prevent further divergent developments. Second, to tackle the structural problems of the EMU, European governments have to resort to measures that can effectively contain divergent developments among EMU economies such as union-wide automatic stabilisers. Therefore, a partly delegation of fiscal responsibilities to the EU level seems to be a sine qua non for restoring a balanced economic development in the EMU.

## 5.7 Appendix

### Empirical approach and data

Macroeconomic and fiscal data are taken from the annual macroeconomic (AMECO) database of the European Commission's Directorate-General for Economic and Financial Affairs. Decomposed fiscal data stem from the IMF Government Finance Statistics.

A time-series approach is applied in order to avoid certain problems surrounding a panel-data approach, in particular 'parameter heterogeneity' (e.g. Temple, 2000), and to take account of the idiosyncratic nature of economic developments in EMU member states.[34] The estimations are carried out for the largest economy of the EMU, i.e. Germany. The data set for Germany ranges from 1970 to 2008. In order to ensure that the regressions are not spurious it has to be tested whether the chosen variables are stationary. For this I apply robust unit-root tests.[35] The bounds-testing procedure by Pesaran et al. (2001), which allows for I(0)- and I(1)-regressors, is applied to test for cointegration. Furthermore, the robust MM-estimator proposed by Yohai et al. (1991) is applied to the regressions in levels.[36]

In order to test whether government activity exerts an influence on current-account balance I use an Autoregressive Distributed Lag (ARDL) model. Once a cointegrating relationship has been established, the order of lags of the ARDL model is selected by applying an appropriate lag-selection criterion, i.e. the Schwartz Bayesian Information Criterion (BIC). In addition, I follow Pesaran and Shin (1999) who propose using a maximum of two lags with annual data. This leads to the following ARDL model:

$$\begin{aligned} \text{abt}(t) = \beta_0 + \beta_1 \ \text{abt}(t-1) + \beta_{2,1} \ g_{\text{prod}}(t) + \beta_{2,2} g_{\text{prod}}(t-1) + \\ + \beta_{3,1} t_y(t) + \beta_{3,2} t_y(t-1) + \beta_4 \ g_{\text{prim}}(t) + \beta_{5,1} \ y_{\text{ea3}}(t) + \\ + \beta_{5,2} \ y_{\text{ea3}}(t-1) + \beta_6 \ r(t) + \beta_7 \ \theta_{\text{pure}}(t) + v(t) \end{aligned} \tag{6}$$

with: $\beta_0 :=$ intercept;

$\beta_{i>0} :=$ regression coefficient;

[34] For a more detailed account of the empirical approach see Colombier (2013).
[35] The results of the unit-root tests can be obtained upon request from the author.
[36] For the benefits of the high-breakdown MM-estimator see Colombier (2009, Section II).

$v$ := error term;

abt := ratio of exports to imports;

$g_{\text{prod}}$ := productive public expenditure, including education and transport and communication infrastructure;

$g_{\text{prim}}$ := non-productive primary public expenditure (i.e. it excludes $g_{\text{prod}}$);

$t_y$ := total tax revenues;

$y_{\text{ea3}}$ := aggregated GDP of France, Italy and Spain;

$r$ := real long-term interest rate of Germany (deflated by consumer price index);

$\theta_{\text{pure}}$ := real exchange rate purified by other regressors of Equation (6).

In order to be able to interpret the regression coefficients as elasticities, I use the ratio of exports to imports as the dependent variable, i.e. the adjusted balance of trade (abt).[37] Fiscal variables are expressed as a percentage of GDP. Note that to avoid collinearity between fiscal variables, estimations are either run with tax revenues ($t_y$) or public expenditure (see Colombier, 2009, p. 902). As productive public expenditure is a share of total public expenditure, productive public expenditure are subtracted from total public expenditure. Moreover, interest payments of the government are also subtracted so that non-productive primary public expenditure ($g_{\text{prim}}$) enters the estimated equation. Finally, the error-correction model, which is applied to the Bounds-testing procedure, is used to estimate the short-term impact of the explanatory variables on net exports (see Table 10, page 112). Moreover, one can infer from macroeconomic theory that the real exchange rate ($\theta$) depends on the same set of variables as net exports (abt) (Colombier, 2013). Thus, the real exchange rate is an endogenous variable. In order to obtain the residual part of the real exchange rate, which is not endogenously determined, I run a regression with the real exchange rate as dependent variable on the remaining regressors of Equation (6). Thus, the real exchange rate is 'purified' from the influence of the other regressors.

[37] Note that the latter can be viewed as an equivalent to net exports (Colombier, 2013).

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# 6 Is a Fiscal Union the Solution to the Eurozone Debt Crisis?

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## 6.1 Introduction

The European unification process intensified with the creation of a common market to allow member countries to benefit from the economic gains of free trade and factor movements in Europe (Keuschnigg and Kohler, 1996). A key turning point was the adoption of a single currency by at first 11 EU countries in 1999 to complete the economic unification process by eliminating exchange rate risks within the Eurozone, creating more liquid and integrated capital markets, and guaranteeing price stability at the Eurozone level (Sapir, 2011). The current financial and fiscal crisis puts these achievements at risk, it has revealed a political conflict over how to deal with the crisis and how to reform the institutions, and it may even endanger the continued existence of the Eurozone in its current composition. It is important to remember that the economic and monetary unification process was driven not only by economic, but also by political goals of establishing lasting peace in Europe in addition to prosperity. The fundamental political objectives, however, are not automatically guaranteed by deeper economic integration. Institutions must be reformed in a way that economic integration itself doesn't become a source of new and dangerous political conflicts.

Should Europe go for a fiscal union? The answer requires a consensus on whether the European Union should move towards a closer political union and develop into a federal state with substantial fiscal capacity at the central level. It depends as well on whether one expects the creation of a fiscal union to be instrumental in solving the current economic crisis in Europe. Section 6.2 analyses the emergence of economic and fiscal

imbalances that led to the current crisis (see also Keuschnigg, 2012a and 2012b). Section 6.3, page 135, discusses the case for a fiscal union and argues that establishing a fiscal union will not address the key problems that have led to the financial and fiscal crisis. Section 6.4, page 139, concludes.

## 6.2 Imbalances in the Eurozone

Prior to the creation of the Eurozone, the European unification process was guided by the notion of subsidiarity. The subsidiarity principle implies that the power to levy taxes, to spend on public goods and services, and to regulate the behaviour of the private sector should be decentralised whenever possible and remain in the realm of autonomous sovereign countries (CEPR, 1994). The introduction of the common currency was a decision to abandon an independent monetary policy at the national level and to transfer the responsibility for price stability to the European Central Bank (ECB). It also eliminated the member countries' independent exchange rates as key relative prices that could adjust to avoid large trade imbalances and unsustainable international borrowing resulting from divergent wage and productivity developments. The smooth operation of a common currency area requires that independent exchange rates are replaced by other adjustment mechanisms. Economic theory of optimal currency areas (OCA) lists four such mechanisms (see, e.g., De Grauwe, 2009, and Beetsma and Giuliodori, 2010): (i) wage flexibility to align unit labour costs with international competitiveness; (ii) labour mobility across regions; (iii) central fiscal institutions to provide insurance against asymmetric shocks; and (iv) strict fiscal rules to prevent negative spillovers of national fiscal policies on other member countries.

### 6.2.1 Divergent Competitiveness and Current Account Imbalances

Until very recently, none of the four conditions for an optimal currency area seems to have been fulfilled in the Eurozone. Only few member countries have reformed their labour market institutions to enable sufficient wage flexibility that could compensate for the exchange rate as an adjustment mechanism. Due to cultural and language barriers, labour mobility across countries tends to be low in Europe and is certainly not

happening to an extent that could significantly reduce the large differences in unemployment and other labour market conditions. There is no central layer of government with a budget that could provide fiscal insurance against asymmetric shocks and thereby dampen regional economic fluctuations. The European Union budget is far too small to achieve any significant automatic stabilisation in the case of negative economic shock. Finally, the fiscal rules of the Maastricht treaty which are intended to limit budget deficits to 3% and debt levels to 60% of GDP have not been credible and have been plainly ineffective in preventing the current sovereign debt crisis in Europe. One must conclude that the consistent violation of those principles, even by large member states led to the current crisis (among others, see Buiter and Rahbari, 2001, Feldstein, 2011, Roubini, 2011, Sinn and Wollmershäuser, 2011).

It is reasonable to assume that the single most important source of the financial and fiscal crises is the divergent development in unit labour costs in Europe, as is illustrated in Figure 10. Eventually, this persistent divergence had to cause large trade and current account imbalances (see Figure 11), leading to an accumulation of net foreign debt of weak countries in the Southern periphery and net foreign claims of other, and more competitive countries such as Germany. In particular, public debt has risen sharply in the low-competitive economies, as illustrated in Figure 12. Over a long time, these divergent trends had been corrected neither by an exchange rate nor a wage adjustment. For an uncompetitive economy, this would mean either an external or an internal devaluation, in both cases making the respective country's exports cheaper on the world markets and imports more expensive. While Germany went through a prolonged period of wage moderation and painful labour market reforms (Hartz reforms), Greece, Portugal, Spain, Italy (and also Ireland, although Ireland's situation is not entirely comparable to the problems of the Southern countries) have increasingly fallen behind. Rigid labour markets and nominal wage stickiness have prevented the required adjustment in these economies. The wage costs per unit of output increase with higher wage rates and decline with productivity gains. When wages and productivity grow at the same rate, unit wage costs stay constant.

The rising unit wage costs in Southern periphery countries have partly been driven by a capital market failure. Figure 13 shows that interest rate differentials in the Eurozone relative to Germany largely disappeared after the introduction of the euro, eliminating risk premia and inducing a real estate and investment boom in the South. The inflow

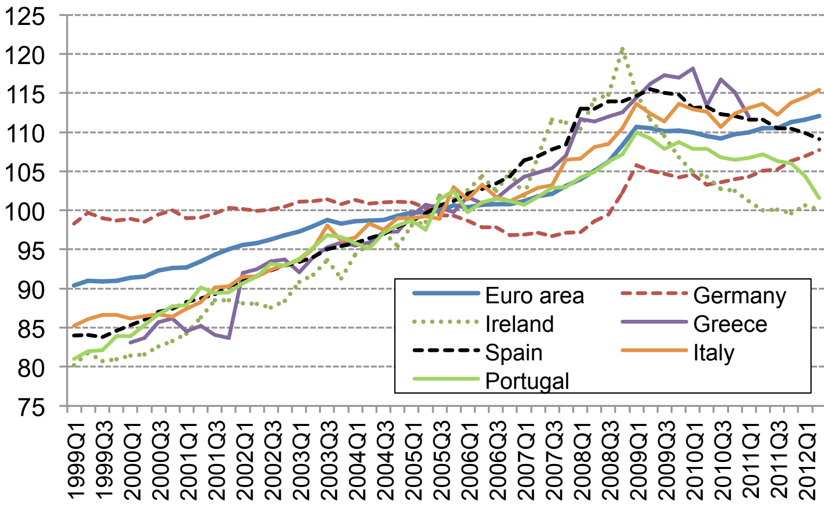


**Figure 10 Unit labour costs (index, 2005 = 100) in Eurozone countries**

Source: OECD; own illustration.

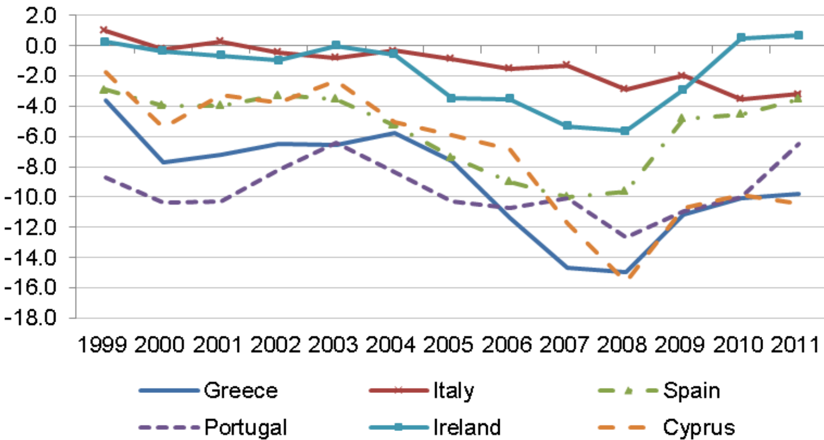


**Figure 11 Current account balance (in % of GDP) in selected Eurozone countries**

Source: OECD; own illustration.

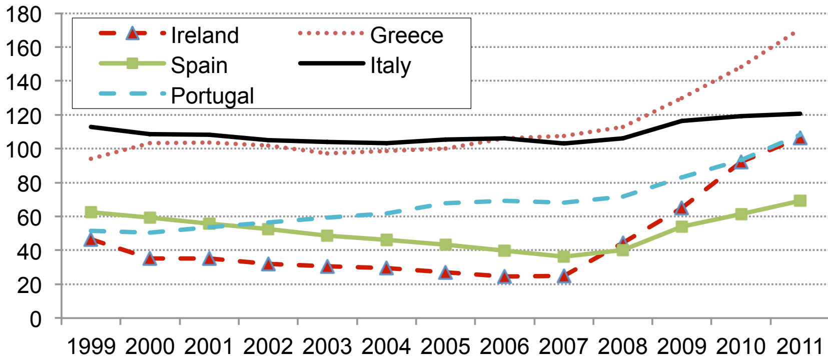


**Figure 12 Development of public debt ratios in selected Eurozone countries**

Source: Eurostat; own illustration.

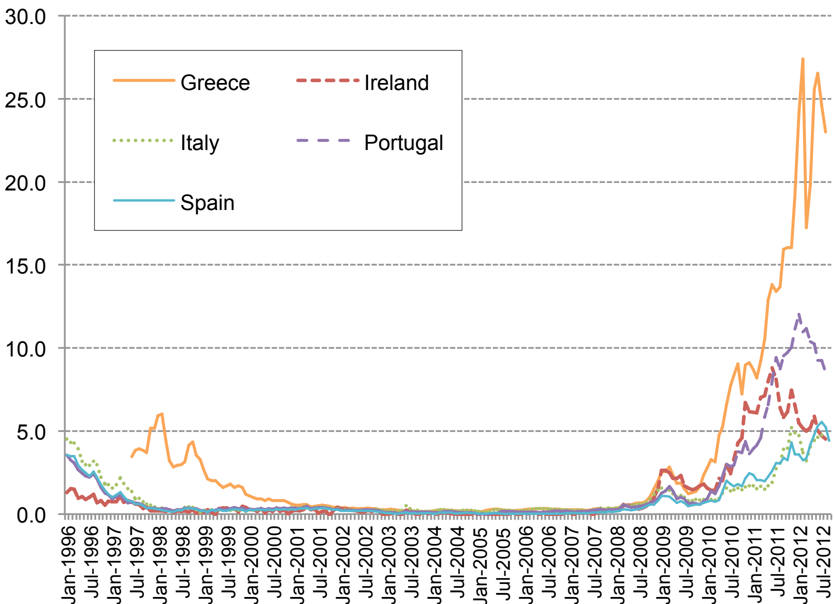


**Figure 13 Sovereign risk premia (government yields relative to Germany)**

Source: OECD; own illustration.

of capital and low capital costs facilitated wage increases not backed by long-lasting productivity gains. As interest rate differentials have appeared again during the financial crisis, a large part of these investments are probably no longer profitable with increased capital costs.

The failure of capital markets to price in risk premia and the resulting allocation of capital towards uncompetitive economies and sectors is probably itself the consequence of lacking credibility of fiscal rules and regulatory failure in Europe. The Maastricht criteria were not effectively imposed and lacked credibility right from the beginning. Capital markets also seemed to conclude that the no bail-out rule would not hold up in crises since bankruptcy of a highly indebted member country would be perceived by the EU to be even more costly (in this way, high debt creates a negative externality on other countries). Given this believe, investors must have expected to get their money bank in any case, making government bonds an apparently very safe investment. Under these circumstances, there was no need to include a risk premium which would have increased interest costs in Southern countries and could have helped to impose market discipline and to restrain the tendency towards excessive debt financing.

The second regulatory failure which probably contributed to the current debt crisis is that equity capital standards for European banks were and still are too low, which creates systemic risk. The weak capitalisation of banks makes them vulnerable to economic shocks and increases the probability of bank failures. Given the linkages and mutual lending in the banking sector, failure of one bank threatens the survival of others (a negative externality) and forces them to cut back lending to the private sector which could trigger a sharp recession, or even a systemic crisis if other banks were pushed into bankruptcy too. Since a country conceivably cannot risk such a very costly course of events, it would always have to bail-out banks. If systemically important banks can expect an implicit state guarantee, they have easy access to cheap and apparently safe funds which creates strong incentives to engage in risky investments. Such a strategy generates very high profits in good times while large losses in bad times might be covered by the tax payer (a negative externality). The implicit guarantee to the banking sector thus facilitates aggressive lending to risky countries and businesses and probably has contributed significantly to excessive lending to the private sector and governments in the Southern European periphery. Higher minimum equity standards for banks are essential to internalise the social costs of risky bank lending. They would make banks more hesitant to engage in risky lending,

to be more careful to evaluate credit risk and to correctly assess the required risk premium. Higher equity standards thereby become a precondition to impose market discipline on excessive deficit financing by financially weak governments and companies. They make banks more able to withstand negative shocks and reduce systemic risks. In making them safer, higher equity ratios should also reduce banks' costs of refinancing on the capital market and should not contribute to higher credit costs to the private sector on average. They would only eliminate those risky investments that are no longer profitable when the risk of failure is correctly reflected in the interest cost. But those investments should not have been financed in the first place.

To sum up, the key problem to be addressed is the divergent competitiveness of European economies, resulting in balance of payments problems and large imbalances of international lending and borrowing. The euro is too strong for the less productive countries in the South and too weak for highly productive countries such as Germany. Even in the absence of fiscal debt, increasing net foreign debt of uncompetitive economies arises when the private sector borrows too much compared to its capacity to generate wage income and profits. Clearly, if both the exchange rate and domestic wages do not adjust, the missing price mechanism leads to accumulating foreign debt, independent of public sector deficits. In part, the euro may actually create and exacerbate fiscal imbalances. Since the euro is too strong for low productivity economies, structural unemployment becomes very high and profits remain persistently low, making firms very vulnerable to adverse shocks. Unemployment inflates social spending and reduces wage tax revenues, low profits further reduce tax revenues and lead to high rates of business failure which may cause further fiscal demands on the public sector to recapitalise banks or important non-financial companies. The developments in Spain and Ireland where fiscal debt was not excessively high prior to the crisis underline these arguments. Clearly, low economic growth and recessions are not conducive to healthy government finances.

In part the above mentioned divergences have been corrected in the recent years. Figure 14 shows that since the onset of the financial crisis in 2008 die prices of domestic production as measured by the GDP deflator has fallen particularly in Ireland where they are now clearly below the Eurozone average. In Spain, Portugal, and Italy prices are currently around the Eurozone average. On the other hand, in Greece the adjustment of price competitiveness has not yet made significant progress.

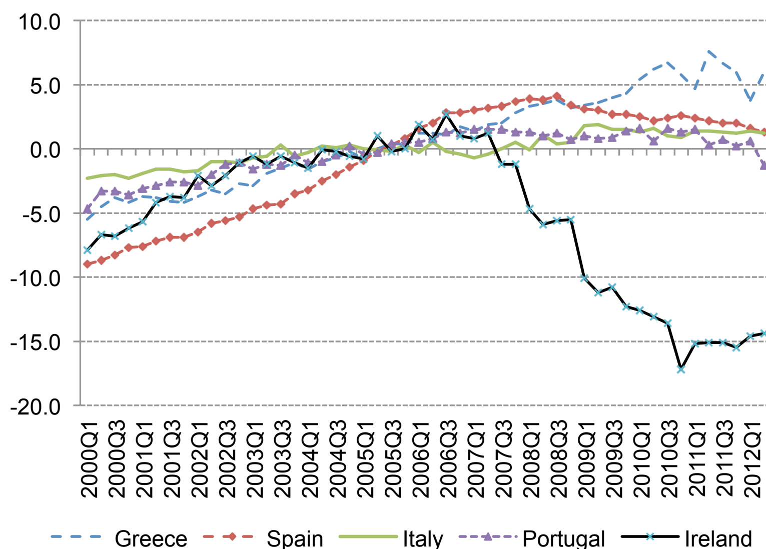


**Figure 14 Development of GDP deflator in selected Eurozone countries (deviation from Eurozone average in percent)**

Source: Eurostat; own illustration.

In 2008, Greece had the largest current account deficit of around 15% in relation to nominal GDP. By the end of 2011, the deficit had been reduced to 10%. This improvement in the current account was predominantly caused by a decline of the trade deficit. In relation to GDP, the trade deficit decreased from 19% in 2008 to below 13% in 2011. However, this adjustment cannot be traced to rising exports as a result of increased international competitiveness, but it was to the larger part caused by declining imports as a consequence of collapsing domestic demand. In the period 2008 to 2011 also Spain, Portugal and above all Ireland could improve their trade and current account positions considerably. Among the southern countries, only Italy's trade deficit remained almost constant, albeit at a much lower level as compared to the deficits of Greece and Portugal. As this analysis shows, while part of the divergences in international competitiveness and current account imbalances has been corrected in the recent years, a long way with painful adjustments has still to be gone by the respective countries. This pertains not only to wage and price moderation, but also to fiscal adjustments to reduce high fiscal deficits and debt levels.

### 6.2.2 Negative Externalities

Negative spillovers on other member countries arise if a country accumulates unsustainable public or private sector debt, and may occur in several ways, including (i) fiscal bail-outs or sovereign default, (ii) contagion via financial markets, and (iii) inflation and/or high interest rates. The first and most obvious negative externality arises if other member countries are more or less forced to bail-out an illiquid or insolvent country to prevent negative consequences of an uncontrolled sovereign default. Large transfers and a redistribution of resources may be required in this case. If a default occurs, wealth is lost in other countries since in an integrated capital market national debt is held by investors or banks in the entire union.

This leads to the second externality, i.e., contagion of other countries via financial markets. Anticipating the risk of default, investors demand a risk premium on newly issued debt, and the value of outstanding debt declines to reflect the higher yield due to the increased risk. The devaluation of government bonds, triggered by unsustainable fiscal policies, destroys large amounts of wealth in other countries, where it is held by banks, insurance companies, pension funds and private investors. If banks are weakly capitalised, as is a main problem in Europe, other member countries may be forced to expend substantial public funds to recapitalise systemically important banks or to protect other investors, at the taxpayers' cost. In the worst case, i.e. when these countries themselves become increasingly exposed to fiscal risk, investors and rating agencies will reassess their sovereign risk as well, leading to higher costs of government financing.

Finally, the nature of the common monetary policy implies that a tendency for debt financing may affect other countries via higher inflation or interest rates. An inflation tax decreases the real value of financial wealth as well as private and public debt in all member countries and thereby redistributes in an uncontrolled way from savers to debtors. The ECB is committed to price stability on the Eurozone level; it is not allowed to engage in government debt financing. Alternatively, given a non-accommodating monetary policy, excessive debt may contribute to a higher interest rate in a common capital market, thereby impeding investment and growth in the entire union.

Any externality distorts economic behaviour. From the perspective of the entire European Union, the presence of negative externalities arising

from high fiscal debt means that individual member countries do not fully internalise all economic costs and might rely excessively on deficit financing. Moral hazard implies that member countries will not be able to fully exploit the gains from European unification. To realise the full gains, moral hazard must be contained, and external costs have to be effectively internalised. This can be achieved by (i) market forces, (ii) fiscal rules, or (iii) banking regulation. In a well-functioning capital market, interest rates should include a risk premium related to the sovereign default risk. The prospect of rising interest costs puts market discipline on individual member countries and helps to restrain deficit financing. The institutional solution, as enshrined in the Maastricht treaty, implements fiscal rules that restrict the admissible deficit and debt levels and punishes countries for exceeding the thresholds. Higher equity standards and tighter regulation of banks can to a large extent reduce the risk of contagion via a weakly capitalised banking sector.

### 6.2.3 Coordination Failures

The interest rate on government bonds serves a key purpose to impose market discipline on government debt financing. It reflects the investors' perception of the risk of not getting back a large part of one's money in case of a haircut as in Greece. Banks and investors, possibly supported by the analysis of rating agencies, must judge a country's ability to service and pay back its debt in full when it is due. The government bond yield is a forward looking concept that reflects a country's future fiscal capacity. It depends on the strength of tax revenues which itself is a function of a country's growth potential. It reflects unfunded pension obligations which entitle workers to pension benefits in exchange for contributions and are a promise no more or less than the promise given to investors to pay back government debt with interest. The risk premium reflects also other expenditure risk such as the need to recapitalise banks under adverse economic conditions or the need to fulfill the guarantees given to fend off fiscal crises and sovereign bankruptcy in other countries. Finally, and very importantly, the risk premium reflects the perceived interest rate risk of a highly indebted country.

The interest rate on government bonds thus reflects the investors' forecast of the future fiscal capacity and of the risk of sovereign default. Obviously, it depends on informed judgement and expectations. In the cases of highly indebted countries, these expectations often depend on volatile investor sentiment and can realistically turn into self-fulfilling

prophesies. Suppose a highly indebted country has accumulated debt in the expectation of historically low interest rates on safe government debt of, say 3%, and suppose the budget is balanced to keep debt from growing further. At this rate, the share of interest spending in total expenditure is reasonably manageable. If the economy gets into a recession or another unforeseen expenditure shock arrives, the budget runs into deficit and the country may experience a liquidity problem. If investors become more pessimistic, they might start to anticipate problems with the country's solvency and revise upwards the country's risk premium. As debt is rolled over and an increasingly larger share must be refinanced at high interest rates (say 6%), more and more of the budget must be reserved for interest payments, leading to a further deterioration of the fiscal position and an even larger risk of default. As interest rates rise even more (see Figure 13, page 127), and the expenditures for debt service explode, the country maybe effectively be pushed into default. The key point is that a highly indebted country with a liquidity problem would still be solvent at normal interest rates of 3%, but is insolvent and must default when interest rates rise to levels of 10% and more. Expectations are self-fulfilling. When investors are optimistic and believe in solvency, they can expect to get their money back and can do with a safe interest of 3%. At that rate, the country is indeed solvent. When investors are pessimistic, they expect to lose their money with a high probability and can lend only with a very high interest rate to compensate for the risk of default. At that rate, the country is indeed insolvent and must default. Volatile expectations can cause large welfare losses as market expectations 'coordinate' on a bad equilibrium (see, e.g., De Grauwe, 2011).

Sovereign risk premia are important to impose market discipline on governments. It is equally important that they be not driven by volatile expectations of nervous investors which might end up in excessive interest costs of countries that face a liquidity problem but are still solvent at normal interest rates. There are arguably three ways to prevent coordination on a bad equilibrium with sovereign default which all involve some form of limited guarantee. The first and crudest way is to require the ECB to give an implicit guarantee by purchasing government debt to stabilise the market and prevent interest rates from rising above a maximum level. In keeping interest rates low, it helps highly indebted countries to stay solvent but does nothing to improve incentives for responsible fiscal behaviour, and may even lead countries to relax and further postpone consolidation efforts. This way has been taken

by the ECB with its guarantee to purchase any amount of government bonds under the condition that the country accepts a strict European Stabilisation Mechanism (ESM) reform program. This ECB announcement is criticised as being incompatible with the ECB's task of price stability and no debt financing of governments. The second way to prevent coordination of a bad equilibrium is the creation of Eurobonds that are jointly guaranteed by all Eurozone member countries and would be rated as very safe. In their crudest form, they would be available to all Eurozone countries at the same interest rate which would be higher for fiscally strong and lower for weak countries, thereby redistributing from strong to weak countries. More refined versions such as Muellbauer (2011) would essentially combine this with administered risk premia, set by an independent EU agency, where revenues could also be used to compensate tax payers in strong countries to compensate for extending the guarantee to weak countries. This would reward fiscally responsible behaviour and make excessive debt financing more expensive. The responsibility to push through structural reform to strengthen the fiscal capacity would remain with the European Commission or other institutions. The third way to address a bad equilibrium with distressed countries risking default are public lending institutions such as the European Financial Stability Facility (EFSF) and its follow up institution, the European Stabilisation Mechanism, and the International Monetary Fund (IMF).

When a country is excluded from the capital market, it may obtain 'conditional' lending by the ESM (in the following, ESM also refers to EFSF) in collaboration with the IMF and the European Commission. A member country can get lending from the ESM only if it accepts strict surveillance and implements a tight restructuring program to restore competitiveness, growth and fiscal solvency (Gros and Mayer, 2010, suggested a 'European Monetary Fund'). Since conditional ESM lending implies a considerable loss of national sovereignty, a country applies for it only if financing on the capital market is no longer possible at acceptable interest rates. The ability to impose a painful restructuring program makes ESM lending different from other sources of funds and allows refinancing of distressed countries even when normal banks do not lend any more. The conditionality is also the key difference to the ECB buying government bonds to stabilise markets. In the latter case, the responsibility to push through painful adjustments to restore growth and fiscal sustainability rests with other institutions. The key advantage of ESM lending is that refinancing cannot happen without an adjustment

program, i.e., refinancing and structural reforms are tightly connected and surveyed by the same institution. In this respect, the creation of a powerful ESM valuably complements existing institutions to support convergence, such as fiscal rules, coordination and surveillance of economic policy, and the limited investments by the EU structural funds. If these institutions fail to prevent divergent competitiveness in Europe ex ante, a tight restructuring and adjustment program under ESM lending may force such adjustment ex post.

The key question remains whether the ESM is endowed with enough financial capacity and guarantees by the member states to be able to handle a speculative attack on government bonds of large member countries such as Italy and Spain. If this happens, very fast policy action and large amounts of financial resources are required. The ESM has proven that under normal conditions it is able to refinance itself on the capital market at low rates, reflecting an "AAA" rating thanks to the paid-in capital and additional guarantees of the Eurozone member states. However, in the event of a sudden systemic crisis, the ESM might no longer be able to raise enough funds in short order to support large countries. A possibility would be to endow the ESM with a banking license, allowing the required refinancing with the ECB. Such refinancing could be limited to well specified and exceptional conditions, and it could only happen when the country subjects itself to an ESM program for tight structural adjustment. Even under these conditions, endowing the ESM with a banking license would imply the interference of fiscal and monetary policies.

## 6.3 Would a Fiscal Union Solve the Problems?

Should Europe become a federal fiscal union with a central government with own taxes and a substantial budget? This question can be approached from at least three perspectives. First, independent of the current crisis, one may discuss the economic arguments in favour of centralisation or decentralisation of different functions of government in a federal state, and how many and which countries should be members of the union. Second, there are important arguments beyond narrow economic considerations in favour or against a closer political union such as establishing peace in Europe or enhancing Europe's influence in world politics. And third, one can ask whether moving towards a fiscal union is a way out of the current crisis and can provide the required conditions for a smooth operation of the economic and monetary union.

In a federal state, some important advantages speak in favour of centralisation (see Oates, 1999, or CEPR, 1994, on vertical assignment of government functions, and Bordo et al., 2011, and Henning and Kessler, 2012, for an account of U.S. history). When there are substantial spillovers from local government activity, centralisation can improve policy outcomes by internalising these externalities. Most evidently, the provision of public goods with community-wide benefits should be centralised to exploit economies of scale. If labour mobility is very high, redistribution and income protection might be more effective at the central level. The argument is that the tax benefit system attracts welfare recipients and alienates tax payers which puts fiscal pressure on individual governments and might lead to a 'race to the bottom'.[38] Centralisation also facilitates decision making and policy coordination, especially when a large number of national decision makers with diverse interests have to come to an agreement, or if the joint benefit of common policies yields different distributional results across regions. Policy coordination and spillovers call for centralisation of macroeconomic stabilisation. If macroeconomic fluctuations are statistically independent or at least imperfectly correlated across regions, the community can gain importantly from insurance against asymmetric shocks.

On the other hand, there are important arguments in favour of decentralisation. Local governments are closer to their citizens and are thus democratically more accountable. They tend to be better informed about local affairs so that decentralised policies are much better aligned with local economic conditions and preferences. Decentralisation also leads to more experimentation in policy making and favours political innovation which may be imitated by other regions. The experience of more innovative governments provides valuable insights about the effectiveness of new policies and sets benchmarks for good practices. Decentralisation leads to fiscal competition that might not be seen as a race to the bottom but rather as a welcome discipline on the excessive growth of government which might arise from adverse incentives in the political process. The EU once adopted the principle of subsidiary which, by default, argues in favour of decentralisation. According to this principle, the member states should be fully sovereign over fiscal policy. Fiscal rules such as the Maastricht treaty or the new fiscal compact should prevent negative

[38] Labour mobility is certainly much higher within homogeneous member states but is traditionally low across culturally diverse European countries. Hence, the argument seems to favour centralisation of redistribution at the national but not at the union level.

spillovers to other countries. While fiscal policy remains under national sovereignty, member countries have ceded considerable regulatory power to establish common markets for goods and services, and protect the free movement of capital and labour in Europe.

A key question is whether a fiscal union could make Europe more of an optimal currency area, provide effective automatic stabilisation of the economy, and help to prevent a repetition of the current crisis.[39] To discuss this matter, it is useful to distinguish the concepts of a fiscal union and a transfer union. A transfer union leads to systematic and long-lasting income transfers and redistribution between different regions such as in Germany after unification which are presumably intended to narrow the differences in income and welfare levels. Such transfers currently occur in limited amounts in terms of EU spending on structural funds which provide co-financing of national infrastructure and other investment to make economically backward regions more competitive. How much they contribute to effective economic convergence is subject to debate. Large and persistent transfers, especially for consumptive purposes, may create substantial political tensions and frictions among culturally heterogeneous regions. Donor countries resent the fiscal cost of net contributions while net recipients resent the conditions and foreign influence that usually come with such transfers. Even within more homogeneous nation states, interregional redistribution as part of fiscal equalisation schemes is often hotly disputed and sometimes creates political forces for separation (the Italian North-South divide, Belgium, or the separation of the Czech and Slovak Republics may serve as examples here). It may be seriously doubted that a large scale transfer union would be politically supported in Europe.

In contrast, a fiscal union is set up to provide fiscal insurance with the aim of smoothing income fluctuations over time and across regions. Insurance means that transfers are transitory and unsystematic. In addition to dampen income fluctuations over time, union-wide unemployment insurance could also smooth income fluctuations across countries. The precondition for a fiscal union is that the unemployment risk is independent and fluctuations are uncorrelated across regions and over time.

[39] Marzinotto et al. (2011) suggest the creation of an EU finance ministry to supervise fiscal policy and assess liquidity and insolvency of member countries. It would have veto rights over national budgets and a taxing capacity of maybe 2% of GDP to be activated in the event of a crisis. They also recommend tighter regulation and supervision of financial institutions and the creation of a Eurozone deposit insurance system for banks.

If countries have structurally different unemployment rates, the system will lead to systematic cross-subsidisation and redistribution as is the case in any system that provides uniform insurance of good and bad risks. Systematic cross-subsidisation within an insurance system may be politically as unacceptable as open income transfers and redistribution across countries with very different cultures. Even worse, when the fiscal union degenerates into a transfer union, it contributes to moral hazard and may slow down reform effort. Cross-subsidisation implies that the cost of high unemployment is partly paid by others and diminishes a country's incentive to actively fight structural unemployment by forcing more wage flexibility and implementing other painful labour market reforms. To avoid this, contribution rates and benefit rules would have to be adjusted to account for country specific unemployment risks. The system would need to specify a much less attractive tax benefit ratio for Spain, Greece, Italy and also France while the package could be more attractive for Austria, the Netherlands and Germany.

The key problem in a currency union is that exchange rate adjustments must be replaced by wage adjustment to offset different productivity growth and divergent international competitiveness. While a fiscal union may be able to insure part of the unsystematic fluctuations across regions, it does not help to eliminate sustained income and employment differentials; in fact, it even aggravate the problem by reducing incentives toward painful labour market reforms. It does nothing to offset the tendency for balance of payment imbalances and accumulating foreign debt of weak and uncompetitive countries. Expanding the scale of structural funds and concentrating them more on weak countries could, in principle, help them to catch up and become more competitive. If not complemented by wage moderation, countries such as Greece tend to have difficulties to fully absorb structural funds and translate them into productivity increasing investments. The experience up to date with structural funds has been rather mixed and it takes much too long to have a significant impact.

If a fiscal union is excluded and automatic stabilisation cannot happen via a central budget, there must be sufficient flexibility at the national level. To dampen short-run fluctuations, automatic stabilisers must be effective somewhere, at the central or decentralised level. Effectively limiting budget deficits to 0.5% of GDP permanently as part of the new fiscal compact may be too strict. If deficits are not allowed to fluctuate enough, member countries might end up with sharper recessions. Fiscal rules should achieve two conceptually different tasks. First, they must

ensure a reduction of fiscal debt over a prolonged period to a low target level of 60% or less, a level that is realistically safe to keep risk-premia and interest costs low. But debt ratios should not be reduced to zero if deficits are strictly and permanently limited to 0.5% of GDP as this would amount in many countries to a huge program of intergenerational redistribution. Second, they must guarantee an effective debt brake that allows debt to GDP ratios to fluctuate around this target level so that fiscal systems can be effective automatic stabilisers. However, as a legacy of past fiscal irresponsibility, the stabilisation function is probably impaired in the first adjustment period.

## 6.4 Conclusions

Moving towards a fiscal union does not address the fundamental problems of divergence in Europe. Given cultural heterogeneity and diverse preferences over the size and scope of government activities, fiscal policy should remain in the realm of national sovereignty, while important regulatory power should be assigned to the European level. Although several different scenarios seem possible, current institutional developments and further reform shall result in a better functioning of the Eurozone. Key developments are: (i) more credible fiscal rules to prevent negative spillovers to other member countries, combined with tighter fiscal and economic surveillance; (ii) more market discipline by a better capitalised and more prudent banking sector with sovereign risk-premia differentiated according to fiscal stance and economic competitiveness; (iii) ESM lending to member countries with liquidity problems subject to strict conditionality. Lending under an ESM program is coupled with painful adjustment programs and will, ex post, impose those reforms to restore competitiveness and fiscal capacity that were neglected ex ante. Restructuring and tight surveillance under an ESM program should much reduce the risk of a speculative attack and forced default of a distressed member country.

These developments should be complemented by further reform efforts: (i) strengthening financial capacity and institutional independence of the ESM, maybe similar to the status of the ECB or the IMF. The mission of the ESM is to provide conditional lending to distressed member countries coupled with tight surveillance of adjustment programs; (ii) tighter regulation and more ambitious recapitalisation of the European banking sector. Higher equity standards will make banks more robust and reduce

cross country contagion in an integrated capital market. They are also a precondition for more prudent lending and for banks to better exercise the required market discipline; (iii) revising the fiscal compact. After a transition towards low target levels of public debt, the debt brakes must allow for sufficient flexibility so that automatic stabilisers can dampen short-run fluctuations. Ultimately, the bias towards budget deficits in the European Union must be turned into a bias towards surpluses, allowing for deficits only in very exceptional circumstances and in limited amounts.

Recent developments and further reforms could internalise a large part of negative spillovers on other member countries arising from irresponsible fiscal and economic behaviour. In a union with very heterogeneous cultural values and preferences, large scale transfers and interregional redistribution are likely to be a constant source of political tensions, in conflict with the political goals of establishing peace and harmony in Europe as a result of economic unification. In contrast, economic and institutional reforms as suggested above should prevent or at least much reduce the negative consequences of national decisions on other member countries and would be more in line with the political goals of European leaders.

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# 7 No Exit, No Bail-out, No Default . . . So What?

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> *"with a single market, a single currency and a single central bank, would it be too bold to envisage a ministry of finance of the Union? . . . it seems that it is not too bold to consider a European finance ministry, but rather too bold not to consider creating such an institution."*
>
> J.-C. Trichet (2011)

## 7.1 Introduction

It has taken a long time for the European Union to digest and accept the iron logic of economic integration. The further countries go down on the road of integration, the more they have to coordinate their policies with one another. After establishing the single market, the EU was brave enough to launch the single currency project, along with the creation of a supranational monetary authority, the ECB. The peculiarity of the new regime was, however, that the common monetary policy was pursued alongside the decentralised system of fiscal policies. Such an institutional asymmetry did not cause any major difficulties in the first few years of the Economic and Monetary Union. In fact, the first ten years of the EMU was a remarkable success story.[40] The euro has become one of the most widely used currencies in transactions worldwide and it has also provided shelter for countries both at the core and at the periphery (European Commission, 2008).

With the European *financial-cum-sovereign-debt-crisis,* however, it has become clear that the original design of European economic governance, which was laid down in the Maastricht Treaty of 1992 and the Stability and Growth Pact of 1997, is not feasible any longer.[41] What seemed

[40] It would be highly misleading, however, to date the origin of a close monetary integration to the birth of the EMU or the single currency itself. The German currency worked as an anchor for many years before the launch of the euro; that is, de facto monetary independence of member states did not exist at all. (Csaba, 2012)

[41] No wonder that right from the onset of the single currency project, several (now classic) studies, such as Buiter et al. (1993) or Eichengreen and Wyplosz (1998), argued that the design of the EMU was inadequate for a stable and viable economic union.

to be a fairly reasonable construction in good times (during the years of the great moderation) turned out to be a highly vulnerable structure in bad times. The crisis compelled Europe to admit that the implicit consent of Maastricht on (i) no exit; (ii) no bail-out; and (iii) no default, is no longer tenable. Simply speaking, Europe is at a crossroads now. It has to decide which way to go and with whom exactly. As opposed to the first three years of the current crisis (between 2008 and 2011), when there was a severe shortage of ideas on the future of the EU, the present is characterized by an abundance of concrete decisions (see especially the establishment of the European Stability Mechanism and the signing of the Treaty on Stability, Cooperation and Governance in the EMU) and bold ideas, such as the creation of a fiscal union.

The chapter provides a critical analysis of the major ideas on the management of the current sovereign debt crisis in one single conceptual framework. Following a short introduction, Section 7.2 provides an analysis of the costs and benefits of the options of an exit, a bail-out and a sovereign default. Section 7.3, page 153, examines the short-term directions that are available for the Eurozone. Section 7.4, page 157, elaborates on the possibility of a fiscal union – as a long-term option for the EU.

## 7.2 The Original Design

The original design of the European monetary zone made it practically and (partly legally) impossible for countries (i) to exit from the Eurozone at any moment in time without leaving the EU as well; (ii) to bail-out troubled member states as it would cause contagion and would destabilise the whole union; and (iii) to initiate an orderly default in order to ease the burden of countries with huge and unsustainable stock of liabilities. But the implicit consent on no exit, no bail-out and no default seemed to become not just too rigid but also obsolete at the time of the eruption of the current global financial and economic crisis. I has also become clear that the E(M)U simply did not have any concrete idea or proposal (not mentioning a timetable) for a sovereign debt crisis which was originally considered as an absolute impossibility.

### 7.2.1 No Exit

Whereas joining the Eurozone requires candidates to meet certain, predefined conditions (i.e., the Maastricht convergence criteria), no such

explicit requirements have been articulated with regard to exiting the Eurozone in the Lisbon Treaty. In fact, no country can decide to leave the EMU, and none of the members can be expelled by the others, either. The only option for getting rid of the single currency is to abandon European Union (EU) membership altogether.

In principle, a return to national currency may boost export and economic activity via devaluation, but it is worth noting that it would also trigger an immediate increase in debt servicing, as national assets (along with incomes) would come in (dramatically devalued) domestic currency, whereas all previously accumulated public and private debts would be still denominated in euro. As an exit amplifies uncertainty, rational households, businesses and investors would be more likely to escape from assets denominated in the re-introduced national currency. The selling of domestic currency would accelerate devaluation pressure, which can easily culminate in not just a liquidity crisis, but also in the total collapse of the national financial system and the economy itself. In the end, it is the exit itself which pushes the troubled nation to renege on its liabilities and announce a default (Eichengreen, 2007).

Although exit from the EMU has become a possibility only relatively recently, the incompetence of European decision-makers to fix the problem of the Eurozone has served as an encouragement for some to put this scenario on the table. Feldstein (2010) for instance proposed a "holiday" for Greece (i.e., a temporary return to the drachma with the obligation of joining the Eurozone as soon as possible). In his view, by temporarily returning to the national currency (and the consequent devaluation of the nominal exchange rate), the country could increase its price competitiveness on the one hand and make fiscal consolidation less painful in terms of reduced employment on the other hand.[42] Rodrik (2010) argued for a very similar "first exit and later rejoining" solution to the Eurozone's debt crisis and claimed that it would be better for the EU to let the ailing member states of Europe to leave the zone altogether than to degrade into a steady economic decline and political resentment.[43] Seidel (2012) added that both Greece and the Community would benefit from

[42] See Baldwin and Wyplosz (2010) for the resentment that this proposal has triggered.

[43] Stiglitz (2010), however, suggested that Germany should quit the Eurozone, since the revaluation of its national currency, the DM, would eliminate surplus in its current account vis-à-vis the rest of the Eurozone countries – an idea that has been echoed more recently by Feeney (2012).

Greece leaving the EU and announcing a partial or total insolvency.[44] Beyond the theoretical disputes, the possibility to exit has become increasingly attractive to politicians as well. Wolfgang Schäuble, German finance minister, infamously claimed that exit should be the last resort for countries which are not able to restore fiscal discipline and national competiveness (Schäuble, 2010).

Even if the EU was ready to allow its member states to choose partial exit (leaving the currency zone but staying within the EU), it would still not guarantee that the costs of exit would entirely diminish. Even worse, since this scenario would require the modification of the Lisbon Treaty, it would open up a time-consuming political bargaining process which could push the whole Eurozone further down the road. Albeit politicians have not ruled out entirely such a scenario, it would increase uncertainty and risk, because no one would know who would be the next in line to be forced to leave the monetary zone. Furthermore, it is highly unlikely that an exit would really help Greece out. It is not simply the record-high level of sovereign debt that prevents the country from growth, but the lack of competitiveness and the poor quality of its public administration and national governance structure. Without the much-needed structural reforms in areas such as the banking sector, the service sector or the public sector, Greece will never be able to return to the path of sustainable growth. Additionally, if Pandora's box has been opened in the form of treaty changes, why not choose instead a more systematic rewriting of the "constitution" – and provide room for a fiscal union for instance?

### 7.2.2 No Bail-out

While the Treaty on the Functioning of the European Union is completely silent on exit, it is rather explicit and straightforward on the denial of a bail-out. It claims that:

> The Union shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State... A Member State shall not be liable for or assume the commitments of central governments, regional, local

[44] In fact, the Greek exit would be pointless without an announcement of bankruptcy.

or other public authorities, other bodies governed by public law, or public undertakings of any Member State... (Article 125(1))

The no bail-out clause has been in the focus of intense and harsh debates from the very beginning of its Maastricht codification. The current crisis has significantly fuelled the debate, and a consensual interpretation seems to be further away than ever before. This is a rather unfortunate state of affairs, as the reading of Article 125(1) undeniably determines the future of economic governance. In the mainstream interpretation,[45] Article 125(1) prohibits both the Union and its member states to bail-out any sovereign in trouble. The argument is simple and straightforward: as long as the Union is capable of isolating itself from the troubled nation, no contagion would threaten the rest of the Eurozone. With such an explicit declaration of no intervention, the EU wished to demonstrate that none of its member states' difficulties can undermine the stability of the currency community. The founding fathers of Maastricht also wanted to ensure that market forces were ready to monitor and evaluate every member country's public finances and punish deviant behaviour. It was strongly believed that financial markets could exert an influence on undisciplined governments.

Retrospectively, it is evident that the no bail-out clause was ineffective in the sense that it did not stop countries to depart from prudent public finances. The departure of some countries put the whole Eurozone and the EU under constant pressure. The expectation of no contagion proved to be incorrect. The remarkable interest rate convergence of 1998 to 2007 made it evident that the previously assumed alarm mechanisms of the private sector did not work at all.[46] The EU-15's real long-term interest rate more than halved between 1992, the start of the Maastricht process, and 2007, the last year before the crisis. One of the greatest beneficiaries was Greece, where interest rate declined from 8.1 percent to 0.9 percent in the given period. In fact, the Eurozone was literally considered as a *single* currency area by the financial world, without any differentiation amongst its member states. The lack of a strong market scrutiny, however, fuelled moral hazard, and countries such as Greece did take on a free ride in terms of accumulating huge debts – which

[45] See especially the decision taken by the German Constitutional Court in 1993.

[46] According to Lane (1993), unsustainable borrowing can be prevented only by effective market discipline, i.e., in case of open capital markets, proper information on the borrower's liabilities and credible no bail-out. McKinnon (1997) claimed that some countries were simply too big to fail; therefore, the no bail-out clause was not considered as a credible option.

perhaps they could never have done without the euro. The defection from the Pareto optimal cooperative behaviour was beneficial from the perspective of the *individual* member state, which could rely on cheap money and maximize its current level of spending and consumption – at least in the short run.

Before the crisis, it was a widely shared view that only countries with national currencies could have difficulties with regard to their external position in general and to their current account balance in particular. Thus, based on Article 143(1) of TFEU, access to EU funds (and bail-out) can be provided only for countries with a derogation. Hungary, Latvia and Romania received substantial financial rescue in the heydays of the crisis, based on this article. The current global crisis has, nevertheless, harshly demonstrated that Eurozone countries are indeed as vulnerable as the rest. It would be reasonable, therefore, to provide EMU members, too, access to mutual assistance (inclusive of granting credits). Accordingly, Marzinotto et al. (2010) claimed that the loan provided for a country in trouble should not be considered by any means as bail-out. The debated article should be best interpreted as a *no-co-responsibility* act, and not as a *no-assistance* act. They also argued that if Eurozone countries were in fact eligible for an IMF rescue, then why should the EU abandon some form of solidarity, too?

In fact, the proposal of the Bruegel Institute (i.e., Marzinotto et al., 2010) soon became a reality, when Greece was granted a loan worth 110 billion euro in 2010. However, the bail-out package was supplied not on the basis of Article 143(1). Instead, the package was put together as a result of Article 122(2), which enables member states to provide loans in times of extraordinary circumstances. "Extraordinary" in this case meant that a new Greek cabinet corrected the 2010 deficit target up to 12.7 percent in November 2009 – well above the 3 percent ceiling of the Stability Pact. Rating agencies immediately downgraded the country, which made the joint visit of the EU and the IMF to Athens in early 2010 inevitable. Due to the warnings of the EU–IMF delegation, the deficit target was modified to 13.6 percent by April 2010. By that time, Greece did not have any other option than to apply for an official rescue package from the EU and the IMF, since long-term interest rates were at a record high of 10 percent. Accordingly, member states deemed the Greek situation an exceptional disaster beyond the control of the country in question.[47]

[47] Council regulation (96/06/2010).

Since there were no structured mechanisms to rely on in the case of extreme situations such as the Greek crisis, the process of crisis management followed a purely *ad hoc* approach which did not calm the nerves of international markets. Investors dramatically reduced their financial exposure to countries at the periphery. The Greek downgrading was followed by the loss of preferred investment status in both Spain and Portugal just weeks after the 110 billion Greek bail-out package was decided upon. It was high time for Europeans to replace *ad hoc,* bilateral loans-based crisis management with a more systematic and deliberate approach.

On 9 May 2010, economic and finance ministers agreed on creating a three-pillar rescue mechanism for countries in trouble worth 750 billion euro (ECOFIN, 2010). The *European Financial Stability Mechanism* (EFSM) became the smallest segment of the new regime, with 60 billion euro. The fund was provided directly by the European Commission through loans borrowed from financial markets. It was created with the undisputable mandate of preventing Greece from default. The second pillar, the *European Financial Stability Facility* (EFSF), became the largest segment of the rescue package, with its originally 440 billion euro mostly in the form of loan and guarantees. The EFSF has been established as a *special purpose vehicle* with its own management board, and issues debt securities, guaranteed by Eurozone member states. The EFSF guarantees are irrevocable and have no conditionalities.[48] The two facilities have been supplemented by the IMF's 250 billion euro financial assistance. One year later, the total financial assistance (in both direct and indirect forms) was increased to 1000 billion euro. Ireland and Portugal have received bail-out via this institutional setup already.

The new European financial construction was placed under immediate fire. In a SWOT analysis, Kapoor (2010) argued that the mechanism was overcomplicated and took too much time for member states to gain access to the pool. Additionally, the European bail-out construction required originally a unanimous decision of all Eurozone countries. The Irish case also demonstrated that the bail-out mechanism could be too expensive for the country in trouble. The high interest payments can cause serious concern and the country may end up in a vicious circle by pushing it to an unintended default. It has not been clarified either

[48] The EFSF comprises the member states of the Eurozone. In principle, the weights attached to individual national commitments are based on their ECB shares.

whether the bond issuance of the EFSF can contribute to crowding out on national debt financing.

Furthermore, from its conception, i.e., from May 2010, the financial construction has been considered as temporary, since financial assistance on a permanent basis was regarded as a violation of the words and spirit of the Lisbon Treaty (its no bail-out clause in particular). Accordingly, the Council regulation that created the EFSF demonstratively defined its mandate in 3 years only. Its temporariness was meant to support the idea that the new financial stability facility was going to fix liquidity problems exclusively and would not be used in case of insolvency. The temporary nature did not simply serve the needs of the Treaty (i.e., respect of the no bail-out clause); it was also governed by a strong political rationality. While managing a liquidity crisis should not necessarily mean risking tax payers' money, a solvency crisis would definitely do so.

The 2010 decisions on establishing a new mechanism for crisis resolution, however, did not convince international financial markets, either. It was still not considered as a credible crisis management framework; thus, peripheral countries had to face record-high interest rate premia on debt securities. Government bonds with a ten-year maturity had a 5.5% yield in Portugal, 4.4% in Spain and 5.3% in Ireland in the summer of 2010 (European Commission, 2011).

### 7.2.3 No Default

Just like the no exit option, the no default principle has never been explicitly stated in EU legislation. In fact, if the text of the Maastricht Treaty (its no bail-out clause) and the Stability and Growth Pact are taken seriously, the option of a state bankruptcy itself was a threatening measure in the hands of the Eurozone. If neither the government, nor the Community bodies shall take responsibility for the liabilities of a member state which violates the rules of the monetary zone (thereby isolating the rest of the zone from the troubled member state), the country which faces a default should in principle go bankrupt. The intention of the founding fathers of the EMU was clear: if countries know *ex ante* that default is a real possibility, no government would lead its country to failure; instead, the troubled nation would embark on a series of consolidation measures to avoid bankruptcy. It was implicitly assumed, therefore, that everyone understood this logic and managed to internalise its consequences in the course of making decisions in public finances. "No default" can be best interpreted therefore as a sort of indirect incentive

to commit member states to fiscal discipline by making default costly and deterring enough.[49]

It has of course always been a valid question whether this assumption was really credible (i.e., no bail-out, together with letting the renitent state to go bankrupt), especially in relation to large countries such as Italy (McKinnon, 1997). Yet, at the time of establishing the EMU, a sovereign debt crisis was deemed simply impossible, since the deepening of economic integration was believed to be based on commonly shared values such as solidarity and reciprocity. Since joining the Eurozone went hand-in-hand with the undertaking of certain explicit and implicit rules and norms (as a sort of gentlemen's agreement), a real default was simply out of consideration, and as a consequence, there was no need to work out its institutional and procedural elements, either. The Eurozone has been left without concrete devices to tackle such situations because of its arm's length approach. The global crisis, however, has confronted the EU with the harsh reality of the opportunistic behaviour of both governments and banks.

Of course, countries cannot go bankrupt in the same way as financial and non-financial corporations do (i.e., assets deteriorate so that liabilities cannot be met in full). It is better to claim instead that default occurs only if the borrower country is not *willing* (or is not capable) to pay to its lenders. Practically, default happens if the budgetary consolidation would be so expensive in political terms that incumbents would not be willing to take the risk of budgetary adjustments.[50]

Gianviti et al. (2010) paint a complex picture of uncertainty with regard to sovereign debt crisis in the EU. The willingness of a member state to meet its obligations is eventually a political question. If incumbents are afraid of a strong social opposition to consolidation efforts, they may decide to renege on the country's debt liabilities. While such a decision

[49] A default is always costly. If it were not, no one would be willing to repay the loan taken out earlier. The most typical costs come with accelerated interest rate premia, or, at its extreme, with the total drying up of market-based external financing. The bankrupt state may be threatened by some other (economic and/or political) sanctions as well, unless the denial of payment comes as a result of an external shock (Grossmann and Van Huyck, 1988). Rose (2005) also underlines the substantial negative effects of defaults with regard to international trade.

[50] It is more correct to use the terms *debt rescheduling* or *debt restructuring* in relation to sovereigns' default. In the former case, the present value of the future payment liabilities is reduced, whereas in the latter case only the lending conditions change (i.e., maturity, interest rate, etc.), and the present value of liabilities remains intact.

may provide some room for the government in trouble in the short-term, it certainly causes frustration amongst creditors and may deteriorate the long-term development prospects of the country for good.[51] However, it is not only the troubled government which implies uncertainty, but also its creditors. It is unpredictable how creditors would react to an announcement of default. Would they be able to work out a consolidation plan together with the government? Or would a minority of bondholders try to block agreement in order to cash out on the default? Prior to the 1990s, it was relatively easier to work out a debt restructuring plan because it was either the sovereigns (Paris club) or the major investment banks (London club) which financed sovereign debts. In the current situation, however, the initiation of debt restructuring is more problematic, due to the extremely large number of creditors. The peculiarity of the EU is that neither the troubled nation, nor other member states (along with international investors) can be sure if political solidarity (i.e., bail-out) or sticking to the words of the Lisbon Treaty (prohibition of a bail-out) would have the upper hand in the game. The fact that decisions are made by the European Council, an intergovernmental organisation, does not ease the situation; in fact, it strengthens ambiguity.

The task force led by the President of the European Council, Herman Van Rompuy, was the first to admit in its final report (21 October 2010) that financial turbulences in one country can have devastating effects on other member countries via contagion (Task Force to the European Council, 2010). The report clearly pointed out that moral hazard has become a serious problem within the EMU. The German–French tandem did not hesitate to launch a proposal that allowed default (or debt rescheduling) in certain cases (28 October 2010). The German cabinet made it clear that it was willing to give its consent to a permanent mechanism only if the new institution was complimented by a sovereign default mechanism. On 17 December 2010, heads of states and governments agreed on the establishing of a permanent crisis mechanism (European Council, 2010). European leaders admitted that an orderly default procedure should be an inevitable part of Europe's redesigned economic governance structure. Otherwise, troubled nations should find solutions to their mounting problems in the form of unchartered disorderly defaults.

The new permanent crisis mechanism, the European Stability Mechanism, will assume the role of the previous two funds, i.e., the EFSM and

[51] See for instance Sturzenegger and Zettelmeyer (2007).

the EFSF, and it will function as the main source of external financing for countries in the Eurozone. The ESM will rely basically on the same instruments as its predecessors, such as primary market purchases, interventions in secondary markets, loans to member states and – as a result of more recent decisions – a recapitalisation of financial institutions. Its capacity to lend will be reviewed on a regular basis in order to provide ample resources to prevent a crisis (Treaty on ESM, 2012).

Most importantly, heads of states and governments agreed that the provision of official financial assistance had to be in line with the current European legislation, and, in particular, it could not violate Article 125 of the Lisbon Treaty by any means (European Council, 2011). As a consequence, the permanent mechanism is to be placed into operation only if the stability of the *whole* Eurozone is endangered (that is, contagion is a real threat). Additionally, the permanent crisis mechanism should not endorse any further moral hazard, a phenomenon which has already seriously damaged and undermined the credibility of the whole system. Prior to the start of the EMU project, one of the strongest arguments against a permanent mechanism was exactly the fear that countries would have borrowed more than without it.

The new mechanism should, however, not only assist the troubled sovereign, but also deter countries from applying for community assistance. The question is how an orderly default mechanism can be a sufficient deterrent. The ESM will provide external financial assistance only if the country in need meets two strict conditions: (i) a rigorous debt sustainability analysis conducted by a panel of independent experts; and (ii) the application of a robust consolidation programme. The former condition is required in order to clarify whether the country was hit by a liquidity or a solvency crisis (European Council, 2011).[52] The sustainability analysis will also have a crucial role in determining what role the private sector should take in stabilising the debtor. If a country turns out to be solvent, private investors are encouraged to take the lead role in financing the debtor.[53]

[52] In contrast to financial and non-financial corporations, however, it is not always easy to draw the line between a liquidity crisis and a solvency crisis. Even if a country is solvent *ex ante,* liquidity tensions can induce insolvency.

[53] This approach was applied in the context of some Central and Eastern European member states in 2009. The so-called Vienna Initiative prohibited foreign banks from withdrawing capital on such a large scale that would have caused the collapse of CEE financial markets. Due to the initiative, the region avoided a solvency crisis which could have been triggered by the otherwise bankrupted banking sector.

If, however, the analyses reveal that the troubled nation suffers from a solvency crisis and no budgetary consolidation effort can put the economy back onto a sustainable path, the member state is obliged to start negotiations with its private creditors. Stakeholders should work out together a credible debt restructuring plan with the aim of restoring sustainability in the realm of public finances. That is, the country is officially allowed to call on a (an orderly) default.[54]

In principle, the threat of a potential haircut (or any other types of debt restructuring, such as longer maturity) can make investors more cautious in their financial decisions in the future. The approach chosen by the EU has its weaknesses, however. On the one side, the new construction wants the creditors to be more active in monitoring and more cautious in investment decisions. In turn, the sovereigns' debt market can be stabilised (by not allowing any country to accumulate non-financeable debt levels). On the other side, the new mechanism expects the same creditors to take out their own shares of burden in case of a default. As a consequence, rational bondholders will have no other choice than to get rid of their risky (and predictably devaluating) assets. The wish to minimize losses will, however, destabilise the market eventually. According to De Grauwe (2011), it is exactly this paradox which has made it previously impossible to put an orderly default mechanism on a global scale into effect.

## 7.3 So What?

Although the single market and the Maastricht Treaty strengthened the Community method in the EU substantially, intergovernmentalism has become the prevailing method in decision-making. It has been basically the European Council (or to put it more clearly, the decisions of the *Eurozone* heads of state and government) which shaped the process of integration in the last two decades. Even more, the current financial and

[54] Although the EU jargon is very cautious in using the term "default", it has admitted the importance of private sector involvement (PSI) with regard to the Greek crisis as early as the summer of 2011. The Greek government was expected to reach an agreement with private investors on a voluntary bond exchange, equalling 50% of the debt held by privates. The PSI also called for an ambitious and credible adjustment programme. On 12 March 2012, the Greek government announced a successful bond exchange worth of 177.25 billion euro. The agreement between the government and private bondholders was one of the conditions for the second Greek rescue package, amounting to 130 billion euro. (Statement . . . , 2012)

economic crisis has given a new impetus to intergovernmentalism. The European Council managed to dictate the pace and the direction of crisis management from the very beginning of the crisis. Decisions in intergovernmental bodies such as the European Council or the ECOFIN are, however, the end-result of a long and non-transparent bargaining process, where political rationality often prevails over an economic one. One of the main reasons for the current paralysis of the European economic governance structure and mechanisms is exactly the slow, ambiguous and discredited political decision-making process. European politicians seemed to be reluctant to take the necessary steps and revitalise the Community method in order to speed up crisis management and create a genuine EMU. Apart from the smallest crisis management fund, the EFSM, which is under the direct supervision of the European Commission, both the EFSF and the ESM follow the typical intergovernmental procedures. (Not to mention the bilateral loans provided to Greece in the first round of its bail-out.)

It is without doubt that the most significant development in the area of crisis management was the creation of the ESM. The governing body of the ESM, however, will comprise of the economic and finance ministers – exactly the same body which was responsible mostly for damaging the original Stability and Growth Pact.[55] In its original version, members of the Board of Governors of the ESM should have agreed unanimously on the most important issues, such as 1) the provision of financial support; 2) the terms and conditions; or 3) any change in instruments which would have made it practically impossible to react swiftly and with the proper measures. But even in its renewed form, an incredibly strong, 85 percent qualified majority is required to initiate the necessary steps in case of emergency which can slow down the reactive potential of the Eurozone substantially. (Treaty on ESM, 2012)

Apart from the crisis management funds, the most important new agreements – such as the Euro Plus Pact and the Treaty on Stability, Coordi-

[55] According to the consensual view, it was the inadequacy of the Stability Pact which was the main cause for debt crises at the periphery. Eichengreen (2012), however, has been right to ask why this deficiency was not recognised well before the launch of the euro itself. It should have been evident (at least from a political point of view) that sanctioning was not a real threat at all because a sanctioned country today can retaliate in the future. In fact, when Germany and France dropped out of the sanctioning process of the excessive deficit procedure in 2002/2003, other countries rightly felt authorised to (mis)behave in the same way. It was exactly the highly opportunistic behaviour of Germany and France that made the Pact ineffective in practice (Crawford, 2007).

nation and Governance in the Economic and Monetary Union (TSCG), which are expected to be the main pillars of the new governance regime in the Eurozone – are a pure manifestation of intergovernmental policy coordination. Although the TSCG aims at becoming an indispensible part of the treaties of the Union, it is, in its current format, an intergovernmental agreement of the participating countries only. What makes its strong position and influence unprecedented is that any financial assistance of the ESM will be strictly conditional upon the national ratification of the TSCG.

In its current form, the European crisis management and resolution is built upon a complex set of institutions and procedures which does not make effective decisions easy. The Community should instead move towards a genuine EMU with supranational bodies and some sort of automatism along with majority decisions. Otherwise, national interest would override the Community's goals and long-term stability. The return to the Community method could accelerate the ability of the Community to respond more efficiently and without considerable lags. It would also imply the strengthening of supranational institutions, which are assumed to be deaf to national goals and pursue the interest of the Community. Both the European Commission and the European Central Bank have the capacity and ability to monitor and evaluate the performance of the individual member states and the Community as a whole. Furthermore, these two supranational institutions would be able to make swift and effective decisions in case of an emergency.[56]

The political leaders of member states have explicitly neglected the European Commission in the last couple of years. Wyplosz (2012) argued that the Commission itself could be blamed for its negligence, too, due to President Barroso's reluctance to play a more ambitious role in crisis management and thereby leave it to heavy-weight politicians to take the required measures.

The situation with the ECB is different, however. Since the ECB is the sole independent supranational body of the Eurozone, it is reasonable to ask what it can do or what it should have done in the context of crisis management. In principle, countries with their own national currencies can easily rely on the support of their central banks as a lender of last resort. The Lisbon Treaty, however, defines the mandate of the ECB

[56] Only recently has the TSCG given more power to the Commission by admitting that the institution does indeed have the capacity and skills to evaluate the economic conditions of member states and the fulfilment of austerity programmes.

much narrowly by enforcing it to guarantee price stability. Only if this objective is not in jeopardy can the ECB support the general economic policies of the EU (Article 127 TFEU). As opposed to the Fed, therefore, the ECB cannot act as a lender of last resort on behalf of sovereigns.[57] By focusing on price stability exclusively, the EU wanted to avoid moral hazard.[58]

The current crisis, however, has made the situation dramatically different. With no common fiscal pools, the idea of allowing the ECB to purchase government debt securities on the secondary market in an unlimited fashion (i.e., to become a lender of last resort) has become more and more attractive. According to De Grauwe (2012), without this role of the ECB, financial stability cannot be guaranteed because "the sovereign and the banks hold each other in a deadly embrace". Stabilising the banking sector by the ECB is a hopeless endeavour without stabilising the government debt securities market, too.

The renewed Stability and Growth Pact, along with the fiscal compact of a decentralised system of fiscal rules, made it easier and more convenient for the ECB to engage in non-conventional methods. First, it was the security market programmes in 2010 and later the long-term refinancing operation (LTRO) in 2011 which drove the Community to unchartered territories. But all these inventions were in line with the Lisbon Treaty, and they were deemed to minimize moral hazard. The September 2012 turnover in ECB policy, however, may raise several questions with regard to its legitimacy. The introduction of the outright monetary transactions (OMT) signals a direct involvement of the ECB in the purchase of sovereign bonds in the primary market.[59] It can be argued that the ECB indeed prevented the Eurozone from a total collapse by engaging explicitly in purchasing sovereign bonds on an unlimited scale. But would it really solve the more fundamental problems of the member states and

[57] Although the ECB is unwilling to act as a lender of last resort, it has been rather keen on accommodating the liquidity needs of the troubled banking sector. The ECB has provided substantial rescue for banks from 2008 onwards. Financial institutions could finance themselves by cheap credit via the regular refinancing mechanisms well below market rates. Additionally, so-called emergency liquidity assistance was provided at a relatively cheap price. In May 2010, the ECB launched its securities markets programme, which was defined as an *ultima ratio* (ECB, 2010a).

[58] The TFEU explicitly prohibits the monetisation of sovereign debt (Article 123(1)).

[59] Following the September announcement of the OMT, risk premia have declined by 100 points in Spain and Italy.

the Eurozone, such as lack of structural reforms and banking and fiscal union?

## 7.4 What About a Fiscal Union?

The idea of a fiscal union is nothing new in the European Union. The MacDougall Report (1977) refused the practicality of a monetary union because European public finances were weak and underdeveloped for "cushioning short-term and cyclical fluctuations" (p. 12). The Delors Report (1989) endorsed the establishment of a monetary union along with an economic one. The Commission wanted to make the economic pillar of the EMU a reality by strengthening economic convergence between member states and also by achieving monetary stability and fiscal discipline. As the single market was expected to reinforce economic interconnectedness within the Community, an intensive and concerted macroeconomic policy coordination was called for in the Report.

From the very beginning of its establishment, the challenge to the stability of the Eurozone has split national economic competencies into two. Monetary policy has been delegated onto the Community level, whereas fiscal policy was left at the disposal of national governments as the sole stabilisation tool. The flaw of the design of the EMU gave birth to a persistent conflict of interest. The only concern of monetary policy has been price stability. Member states, therefore, could use only domestic fiscal policy in order to serve their national interest.

The current crisis seems to verify the earlier claims on the negative consequences of institutional asymmetry and fuels a new wound of debate on a fiscal union. But what is exactly a fiscal union? Unfortunately, there is no a single and precise definition for it. Even in its most preliminary form, a fiscal union must mean some degree of delegation of national sovereignty in terms of tax collection and public spending. The current form of fiscal integration is, however, still very far from it. The most recent debates, led by Germany, envision a bold and challenging step forward on the road to "an ever closer union" by initiating a clear transfer of sovereignty to supranational entities. One of the first such proposals was put forward by Jean-Claude Trichet, former governor of the ECB.[60]

[60] Trichet argued for a more federal structure of the EU as early as 2010. He underlined that in the absence of a federal solution, "responsibility for the economic union itself – as part of the economic and monetary union, the EMU – rests with the Member States themselves" (Trichet, 2010).

He favoured a two-stage approach in crisis management. First, countries facing temporary shortage of liquidity must be guaranteed an EU rescue. Financial assistance, however, should be based on serious conditionalities in order to minimize moral hazard. However, if the troubled nation fails to comply with the agreed terms in the first round, the "Eurozone authorities [should] gain a much deeper and more authoritative role in the formulation of that country's economic policies." (Trichet, 2011) According to his proposal, European authorities (and necessarily the European Council) should play a much more decisive role in this second phase. He called for the establishment of a European finance ministry which would represent Community interests and would take authority over issue areas such as public finances and structural policies.

Marzinotto et al. (2011) also called for a fiscal union and elaborated on the functioning of a finance ministry in a detailed manner. The new ministry would scrutinise national policies and could veto inappropriate decisions if these threatened the stability of the Eurozone.[61] The finance ministry would have the power of taxation and could initiate spending. Such an authority would be able to act swiftly and efficiently in case of an emergency. Most importantly, the new institution should act as a lender of last resort for the benefit of sovereigns in case of a liquidity crisis.

For the Tommaso Padoa-Schioppa Group, fiscal union is a vital step towards the completion of EMU (Completing . . . , 2012). It promotes a *sui generis* approach to fiscal federalism and takes the following position: *"The single currency requires as much fiscal federalism as necessary for its appropriate functioning, but as little as possible."* (p. 5) The authors advocate a decisive shift from the current practice of intergovernmentalism to the Community method empowering the European level to act on its own. A "full-fledged and autonomous actor" on the EU level (p. 17), however, requires countries to give up their sovereignty to some degree. This would necessarily be the case when a member state would not be able to finance itself anymore from the market and would require financial assistance from the common fiscal pool. In principle, "sovereignty ends when solvency ends" (p. 7). Although the Tommaso Padoa-Schioppa Group would not call the new European-level institution as a finance ministry or treasury, its main functions and mandate would not differ extensively from the proposals of either Trichet (2011)

[61] In case of insolvency, the appointment of domestic key senior policymakers would require the consent of the European finance ministry.

or Marzinotto et al. (2011). In fact, their European Debt Agency would be chaired by a finance minister who would monitor the compliance of the Eurozone member states with the rules of the zone in normal times, and who would take over decision-making on public finances in times of insolvency.

What is common in the proposals is that due to the highly integrated nature of financial markets and the intricate relationship between banks and sovereigns, the new institution should play an active role in establishing and running a pan-European banking supervision. More importantly, in the future the common fiscal pool would be used to rescue banks operating on the common market. Until now, member states were expected to be ready to bail-out their national banks in case of an emergency. This practice was explicitly endorsed by the October 2008 decision of the heads of state and governments, which made sovereigns the ultimate agents of banks. The sheer size of such bail-outs in 2008 and 2009 was so tremendous that the debt of the general government increased dramatically in some cases. (Due to the bail-outs, the stock of public debt quadrupled in Ireland, for instance.) Henning and Kessler (2012) underlines that the federal level in the US is not simply responsible for macroeconomic countercyclical stabilisation but it has also been assigned the role of recapitalising and restructuring banks. Europe would, therefore, follow the American example.

Despite the attractiveness of the current proposals on a European fiscal union, several questions need to be addressed. One of the unique characteristics of the Eurozone has been that member states were left absolutely alone in case of an asymmetric shock. Without national currency and autonomous monetary policy, member countries could rely on fiscal policy as the only shock absorber. Fiscal space, however, is largely restricted by the strict conditions of the rule book of the Eurozone (and the space will be even further narrowed by the new TSCG). Countries often found it difficult to conduct countercyclical stabilisation in the EMU regime. In principle, a fiscal union would provide a solution to this problem. The federal level could always be activated in case of asymmetric shocks. Nevertheless, challenges are manifold. For instance, "it is not straightforward to separate the insurance effect of fiscal equalisation, which is crucial for macroeconomic stabilisation effect, from the income redistribution effect" (Fuest and Peichel, 2012, p. 6). The two effects (i.e., insurance effect *versus* income redistribution effect) differ from each other substantially. Insurance means an *ad hoc* and transitory intervention with the aim of reducing fluctuations in income over

time. Income redistribution, however, means a permanent transfer from one region (or country) to another by definition. It is better to refer to such a system, therefore, as a “transfer union”.

There might be some level of consensus amongst member states to commit themselves to a sort of insurance effect, but nothing guarantees that they would be able to agree on a fiscal union with income redistribution effects. According to the current state of affairs, the fiscal union would be activated only in case of emergency, and it would work as a sort of shock absorber. That is, it would not take the typical role of a redistributive authority in order to channel taxes from more developed and competitive regions (countries) to disadvantaged ones. However, all major historical studies on the US and other federations seem to have one point in common. Fiscal unions can work effectively only if they take on the role of income redistribution as well besides the insurance effect (see especially Bordo et al., 2011, and Henning and Kessler, 2012). Considering the serious imbalances in the level of economic development and competitiveness in the Eurozone, income redistribution might be a reasonable longer term objective – even if it would mean a transfer of taxes on a permanent basis.

First, Europeans have to agree, therefore, on what type of fiscal union they want to create. It seems that Germany, Finland, the Netherlands and some other member states (basically the ones with a solid fiscal position) strongly oppose any type of transfer union, whereas troubled nations allied with France seem to prefer such a solution. Needless to say, without strong political commitment, no common fiscal pool can be permanent and successful.

The critics of the Eurozone have always underlined that without a common budget of the size of federal states such as the US, the EMU would never be able to qualify for a well-functioning and stable monetary zone (see especially Feldstein, 1997, or Krugman, 2009). Federal budgets have typically a size of 25 to 35 percent of the GDP. However, none of the previous proposals target such a large budget. In fact, these sources argue for a budget of roughly 1 to 2 percent of the Eurozone GDP. With that size, the finance ministry would have a substantial borrowing capacity, enabling the finance minister to raise funds from the market at a much lower rate than the troubled economy would be able to do. But it would not allow the new Community body to initiate permanent transfers in order to reduce inequalities in terms of economic development. The fiscal union would be a kind of preventive and crisis management and resolu-

tion facility, and it would not aspire to lay down the foundations of a political union.

But if this is really the case then would such a fiscal union really differ that much from the current ESM? The ESM is a fundamental innovation but it cannot be considered as a lender of last resort in any sense. Its capacity is limited and decision lags might be substantial. The European Council, with its preference on intergovernmental solutions, wanted to design a crisis resolution mechanism, i.e., the ESM, which is a non-mandatory and market-driven construction.[62] If the proposed fiscal union would be contained to initiate stabilisation only, an ESM developed into a full-fledged bank, backed by the ECB (or even a European Monetary Fund), would probably be a superior solution to a fiscal union. Especially if the factor of time is taken into account: whereas an ESM with more fire-power would require a relatively short period of time to establish, the creation of a fiscal union is definitely a long-term project.

Fiscal union, however, would imply a clear move towards the institutionalisation of a centralised and mandatory remedy to the current paralysis. While the legitimacy of the ESM is based only on an intergovernmental treaty, the European finance ministry would become a Community-level institution. If its legitimacy is well-established (for instance it would be accountable to the European Parliament and its work is controlled by a fiscal council), the new finance ministry would be a powerful institution. It may have the right to collect taxes and veto national economies policies. In fact, it would act as a lender of last resort on behalf of sovereigns.

The new finance ministry as a lender of last resort could ease the pressure currently put on the ECB. The ECB's direct purchase of debt securities on the secondary and especially the primary markets is highly questionable from the perspective of legitimacy and accountability. The dramatic shift from its earlier rigid interpretation of the no bail-out clause of the Lisbon Treaty may fuel fears in the Eurozone. With the help of monetary policy, the idea of a transfer union can become a reality –

[62] The intergovernmental Treaty on ESM (2012) itself was signed first on 11 July 2011. Half a year later (23 January 2012), the economic and finance ministers initiated modifications in order to improve the efficiency of the ESM (incorporating all relevant decisions made previously, especially the ones of 9 December 2011, making it possible to act on the basis of a qualified majority in case of an emergency). The new treaty was signed on 2 February 2012 and parties agreed 1 July 2012 as the date for the treaty to enter into force.

without, however, having the consent on such a drastic development of the constituting members of the E(M)U. At its extreme, an unintended consequence of the ECB's OMT could be that countries opposing the mutualisation of debt would themselves consider the exit from the EMU as a reasonable option. The fact that the ECB's decision has not been supported unanimously is well represented by the harsh battle between the Bundesbank and the ECB. The ECB can temporarily stabilise markets but it does not make the Eurozone more attractive in the eyes of fiscally conservative German taxpayers. It is also disputable whether investors find such a time-buying solution convincing enough. Any further increase in uncertainty will seriously undermine the position of more peripheral countries and even the credibility of the ECB can come under pressure.

## 7.5 Conclusions

If the ultimate objective of European integration is a political union, this aim can be served much better in the medium or long run by a fiscal union than by an ECB with unlimited capacity to mutualise debt in the Eurozone. Creating a lender of last resort for sovereigns requires the decision of the member states. Fiscal union indeed would be a quantum leap towards a political union, where federal Europe takes over much of the sovereignty of the member states. Europeans therefore should lay down the solid basis of a new fiscal union carefully.

Right now, it is the pressure of sovereign defaults and the fallout of the entire monetary zone that determines the steps in constructing the basics of a fiscal union. Ideally, however, a fiscal union should be established independently from the current crisis situation. The design of a fiscal union cannot rely purely on the wish to create a functioning crisis resolution mechanism. A fiscal union should imply more. Elaborating on successful federal entities, Bordo et al. (2011, p. 24) found that "all the fiscal unions evolved in close interaction with the political unions forming the ultimate basis for fiscal cooperation". The EU is, however, very far from this ideal at the moment.

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# III

# Eurozone Beyond Economics

# 8 Multiannual Framework Negotiations and the Missed Opportunity of the Eurozone Crisis

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## 8.1 Introduction

Most of the EU's policies are implemented by her Member States, using their own budgets. The EU budget finances issues that the Member States cannot fund on their own or which they agreed that they can fund more economically by pooling their resources through the EU budget. The present EU budget is small, 1.01% of EU gross national income (GNI).[63] The criticism of the current state of the EU budget has been long, widespread and increasing. The 2003 An Agenda for a Growing Europe summarised the most pressing problems of the current situation in the EU and the position of individual Member States toward the size, role and level of redistribution of EU budget as follows:

> As it stands today, the EU budget is a historical relic. Expenditures, revenues and procedures are all inconsistent with the present and future state of EU integration . . . The procedure for adopting the EU Financial Perspectives . . . is driven by narrow national calculations of self-interest, bolstered by unanimity voting. For these reasons, the successive negotiations to renew the Financial Perspectives for a five or seven-year period have always followed the line of least resistance, which consists of modifying, at the margin only, the financial allocations of the previous period. As a result, the current budget is more the expression of different deals and attempts by governments to claw back in receipts as much of their

[63] 2011 budget, PA payment appropriations.

contribution as possible (juste retour ...!)[64] than a coherent set of measures aimed at pursuing EU objectives (Sapir, 2003, p. 162).

It, thus, complains not only about the policies the budget finances but also the way it is negotiated and adopted.

The recent financial and economic crisis neglected another weakness of low size of EU budget in comparison with fully flagged monetary unions and federal states – the non-existence of stabilization function of the budget. The crisis in the EU developed into a debt crisis in the so called peripheral countries of the Eurozone (Greece, Spain, Portugal, Italy and Ireland). The need for existence of a federal budget in a monetary union is not a new idea. Already in 1970s, the so called MacDougal committee (1977) suggested that a federal budget of the size of 5–7% of EU GDP would be appropriate to support smooth functioning of a monetary union. In the 1990s, some European economists such as Paul De Grauwe (1999, 2013) or Beetsma and Bovenberg (1998) further highlighted the need of a federal budget for the Eurozone but the euro came into being in 1999 without having been supported by any increase in the size or scope of the EU budget.

In this chapter we wish the analyze two issues – the size of the budget for Eurozone and the bargaining skills and positions of the EU's institutions and Member States, and how their 'political powers' are utilized. We show that while there seems to be a growing consensus that the EU budget needs a significant reform and while there even seems to some level of consensus on the form of the reform, the probability of such reform is less certain. Path dependency, political and economic conditions, and rising disillusion with the project of European integration due to Eurozone crisis seem to hinder such development.

## 8.2 Financial Framework Negotiations

The Council is still considered to be the key institution in the whole process of MFF negotiations, which have so far been dominated by national rather than communal interests (Rant and Mrak, 2010, p. 348) MFF negotiations represent intergovernmental negotiations, so called grand bargains, therefore, are different from daily decision making processes. Among the Member States there is a pressure to come to some agreement and no-one wishes to see the negotiations collapse. A crucial role is

[64] *Juste retour* refers to a principle when member states receive approximately as much as they pay into the budget.

played by the European Council but also the presidency and the Council system. Negotiating the budget framework dates back to 1988 and is crucial in determining EU commitments for periods of seven years. They set the medium and long-term goals of integration. Originally submitted by the Commission, the proposal is discussed in the Council and formally adopted by the European Parliament. In the Council, most negotiations take place in the General Affairs and External Relations Council and – even though to lesser extent – in the Economic and Financial Affairs Council (EcoFin). Then, the European Council has to approve it unanimously followed by an inter-institutional agreement among the Commission, Council and Parliament. The EU budget gives substance to European integration in both widening and deepening and reflects relations among EU Member States and the institutional setting. It has a geographical (regions) and sectoral (policies) dimensions (Blavoukos and Pagoulatos, 2011, pp. 565–566).

The MFF packages consist of three parts, MFF regulation, own resources and sector specific acts. Each part has different rules of negotiations. MFF regulations have to get unanimous consent from the Council after consent of the European Parliament, which approves or rejects but cannot amend. Own resources are covered by five legislative acts, the basic one adopted by Council's unanimous vote and the implementing ones by qualified majority vote (QMV). Parliament must give consent to the implementing one and an opinion on the other four. Sector specific acts are adopted by Council and Parliament under co-decision procedure. During the negotiations not only how much each state will pay and receive is decided but they also specify programmes on which money will be spent for at least five years. It establishes ceilings of maximum amounts that can be spent each year on each area – known as headings. It also establishes the total maximum ceiling. These ceilings are not objectives so the actual annual budgets are usually lower except for Cohesion policy where the ceiling is considered an objective. Most of the changes to the proposal and thus also negotiations occur in the Council where national governments negotiate how much they have to contribute to and how much they will receive from the EU budget. In takes place on four different levels – technical experts in working groups, ambassadors in COREPER, ministers in the Council and Heads of State in the European Council. The Council also keeps a dialogue with the Parliament.

The Commission presented its proposal at the meeting of EU Foreign Affairs Ministers on June 29$^{th}$ 2011, the first formal exchange took place on September 12$^{th}$ 2011 during the Polish presidency, and it was first

on the agenda of the General Affairs Council in March 2012 and of the heads of states in June 2012 at the European Council summit. The first six months under Polish presidency were dedicated to reading and analysis, the next six months under Danish presidency to discussion and the conclusion was expected from the last six months of 2012 under the presidency of Cyprus. After the Council meeting in July, Cyprus held an informal meeting in August, which aimed at becoming the "moment of truth" (Euractiv, 2012). In its aftermath, the deputy minister for European affairs identified the main issues of conflict as "level of spending and content under each chapter ... as well as ... new revenue base for the EU" (Evripidou, 2012). The presidency also stated that the amount proposed would "have to be adjusted downward" while the EP claimed to block any agreement if spending was cut (Kovacheva, 2012). In mid-November 2012 President Van Rompuy presented a modified proposal with significant cuts of 75 billion euro, mostly for agricultural (CAP) and regional policies. The proposed cuts by both the Cyprus Presidency and Van Rompuy were met with uneasiness in all Member States, the Commission and the Parliament. The European Council negotiations in November failed and were re-launched and concluded in February 2013 under the Irish presidency.

November 14$^{th}$ 2013 Parliament and the Council struck a deal on the Multi-annual Financial Framework for years 2014–2020. This was a prerequisite for Parliament to approve the MFF, because MEPs wanted to prevent the EU from starting the first year under the new MFF with a deficit. European parliament finally approved the EU's long-term budget (Multi-annual Financial Framework – MFF) for 2014–2020 at the plenary session November 20$^{th}$ 2013.

During the negotiations, as usual two main groups emerged, net recipients against net contributors. These were further fragmented. We had those who received most payments from structural and cohesion funds (Greece, Poland, Estonia, Latvia, Lithuania, Hungary, Slovakia) and those who received most payments from CAP (Latvia, Poland, Spain, Slovakia, Portugal, Estonia, France, Slovenia). Some countries favoured a reform of the CAP, particularly moving more resources away from direct payments towards rural development (Czech Republic, Denmark, Netherlands, Sweden, United Kingdom, Italy, Malta). In case of cohesion policy, many countries wished to see support only for the poorest regions disrespectful of the country, others wanted to preserve current situation when every region could receive some money. There was also a discussion on the reform of the revenue side of the budget. Most Member

States would agree to eliminate the VAT source but there was disagreement on whether to rely on the GNI contribution only and even more so whether to introduce some kind of EU tax, namely an EU financial transaction tax (FTT).[65]

The nature of MFF negotiations involves high politics, zero-sum game expectations and strong national interest focus. Rant and Mrak (2010) identify several factors that need to be taken into account when considering a reform of the budget. The Council is THE most important institution in budget negotiations and it is dominated by national interest. Different items in the budget have different weights with the domestic public and the governments can be tied by strong domestic lobbies' influence, domestic decision making structures (for example federalism, coalition governments or strong parliamentary control). The final balance is then carefully followed by the media. The result is highly visible and followed by national electorate which expects net benefit. Solidarity is limited. Countries' power depends a lot on their economic power rather than just number of votes in the Council.

Finally, the structure of expenditures highly favours old Member States, who receive almost 50% of cohesion and 80% of agricultural policies funding, i.e. despite general perception, most of the redistribution takes place among the wealthy, which makes the poorer states particularly sensitive to their net benefit situation (Rant and Mrak, 2010, pp. 365–366). Given that net balances are easy to calculate and we can assume from the conduct of previous negotiations that the basic national interest is to maximize net balances[66], the motivations of the actors are clear to their

[65] In October 2012, the agreement was finally reached and enhanced cooperation on FTT was agreed. In a formal letter to the Commission, seven countries expressed their support, Germany, France, Austria, Portugal, Belgium, Slovenia and Greece, later joined by Italy, Spain and Slovakia. Thus, the minimum of nine countries was met and in October the Commission submitted a proposal to the Council (European Commission, 2012).

[66] In the previous negotiations for 2007–13 framework, six main contributors, Germany, France, UK, Netherlands, Austria and Sweden, requested budget restrictions which the Commission's proposal ignored, and demanded relative expenditure level to be fixed at 1.14% of EU GNI (they demanded 1%, the previous framework worked with 1.08%). The final outcome of the negotiations scaled down to the 1% as demanded by the Six. Also, the expenditures went against its proposal – away from competitiveness and internal policies towards agricultural and cohesion policies. This indicates a strong prevalence of national over communal interests where the individual Member States try to maximize their gains as these are the most visible results of the negotiations to their domestic audiences "since they are easy to explain to the public and carry implications for national fiscal policies" (Rant and Mrak, 2010, pp. 350–352).

partners. Given the need to present the position as a one in favour of the common good, we often see two basic references – the net contributors refer to the previously agreed need to reform public spending in their national environments and link national budgets to EU budget. The cohesion friends then refer to the principle of solidarity and the need to help poor regions. Where the system of *juste retour* dominates, the public expects returns and a return with a positive account. The statements of most Member States are contradictory in terms of expectations and payments. While demanding fewer expenses, they request more or less equal CAP spending, generous structural funds and improving R&D, innovation and competitiveness. Thus, it often happens that most countries who call for less budget also expect more spending in particular headings important to them.

Alliances based on socioeconomic convergence/divergence are very important in case of EU budget negotiations. In conventional MFF, the Member States create alliances when presenting positions or defending them in the Council to put pressure and convince others. Yet, the composition of the alliances and their positions are subject to change. Their proposals mostly represent attempts to demonstrate common position and strength vis-à-vis the other actors. Kölling (2006, p. 9) refers to them as process coalitions which "served to clarify standpoints and the existing balance of power". In the end, all national delegations stand alone and are more than often willing to accept side payments for softening their individual positions. Common positions are tabled especially in early days of negotiations, but gradually individual strategies, preferences and interests prevail.

MFF negotiations are highly visible and politically sensitive, they are "high decibel … vested with considerable political drama and last-minute agreement" (Laffan, 2010, p. 725). Despite the relatively small size of the EU budget, the negotiations are particularly conflictual because of their significant redistributional dimension – almost 80% of the budget. The Member States avoid reform for as long as the unexpected costs are hard to predict and perceived as high. Following the path dependency argument, very little change could be expected. If we apply the concept of "punctuated equilibrium", which assumes that status quo prevails until a rapid change takes place, then we need to determine whether of point of radical change has been or will be achieved to be able to implement a true reform of the budget. We can assume in the same line of thought that if the process proves to be a "lengthy and complex trial and error process" (Finke et al., 2012, p. 1). The need to change it will become

more pressing and obvious even to those who traditionally oppose it and it will give advantage to the pro-reform actors able to control the process. It will be their propositions that will determine the future shape of the reform.

The EU budget reform seemed very unlikely but many unlikely reforms in the past got through – such as the Lisbon treaty, which even though modified, the main – and often quite controversial – elements remained in place. We argue that "as long as the majority of Europe's political leaders can agree on reform they will find strategies to realize it" because of their interest to do so and not based on the lowest common denominator or a set of common norms (Finke et al., 2012, p. 9). In the situation when a reform is proposed, the actors evaluate it by comparing it with the current state. Thus, if the situation becomes dire, the proposal for reform is a welcomed way out but it needs to be an improvement when compared with the current state for a majority of actors. The other actors, most resistant to change as they benefit most from the current state (which can also be the inability to agree as it undermines the credibility of the EU) will bend in when consensus majority is reached and the cost of being the odd one out becomes too high. A symbolic sacrifice is often sufficient to make them join the reform without 'losing a face'. Thus, when making a reaction, they take into consideration status quo, (expectations of) other actors reactions and expected domestic consequences especially those important for the pursuit of their domestic interests, i.e. political parties and voters (Konig and Finke, 2012, p. 105).

Much depends on the skill of the main negotiator or mediator and their ability of strategic leadership to control the agenda. Timing is also crucial. The enlargement fatigue, the legacy of the Lisbon treaty lengthy adoption process, the financial crisis and the ongoing Eurozone crisis presented a specific environment, which could have become a critical moment for change because national governments could present the budgetary reform to the media as a necessary step to avoid further costs. As Laffan (2000, p. 727) says, "while there is a high level of path dependency in institutional development, institutional process may be transformed when a critical moment is transformed into a critical juncture" based on the argument of Bulmer and Burch that specific events can create critical moments which turn into critical junctures if taken advantage of and a "institutional development moves on to a new trajectory or pathway at which institutional development moves on to a new trajectory" (Laffan, 2000, p. 727). Timing, strong leadership authority, together with specific developments in some Member States could have grasped

the momentum but they did not so the reform has to wait for another, more suitable, moment. In the end it is inevitable as problems are not solved but pushed into the future. Each time the reform fails, its need becomes more pressing in the future.

Rant and Mrak (2010) saw only two political solutions that could lead to a radical change in the budget – strong external pressure or institutional reform strengthening the Commission and the Parliament in the framework negotiations. They, however, acknowledged that the Lisbon treaty exercise made the latter rather improbable, which left us with some form of external force. The crisis and fiscal problems even in the wealthiest EU countries caused a lot of scepticism about the EU budget and lowered the will to comply with solidarity especially across the Eurozone countries whose public felt anxious after the bail-outs for Greece. Anti-EU sentiments grew and anti-EU populism was strong. The Eurozone crisis created additional conflict in the negotiations due to the Member States' unwillingness to pay more into the EU budget while requesting more payments and more flexibility. The failure to agree, the difficulty of the negotiations, the significant increase in extreme positions, and the role of the European parliament were all crucial for the outcome of the negotiations.

## 8.3 European Commission and European Parliament Towards the MFF 2014–2020

According to the European Commission, the budget lacked flexibility to respond to "political imperatives and changing circumstances". The 2010 EU Budget Review mentioned the economic crisis, which "underlined the interdependence of the EU's economies and the need to strengthen common rules". Possible mechanisms for stabilising European economy were "tightly constrained by the ceiling of own resources". It criticised the 2007–13 framework structure due to its focus on net balances, which "was given priority over measures designed to improve performance" and did not give primary consideration to European dimension. Consequently, "the 'juste retour' debate … had a negative impact on the quality of delivery and reduced the EU added value" (EUR-Lex, 2010). The EU added value defined as "value resulting from an EU intervention which is additional to the value that would have been otherwise created by Member State action alone", was again emphasised in the Commission's proposal published in June 2011 and is also advocated by the European

Parliament for whom it "should also contain a visionary aspect" (European Commission, 2011).

The European Parliament was also supportive of a change and issued a challenge to the Member States, who wanted to freeze the EU's 2014–2020 budget: it requested that these countries spelled out which priorities they would drop as a consequence of the imposed ceiling. MEPs felt that freezing future budgets at the 2013 level was "not a viable option" (EP, 2011). If all the objectives and policies agreed for the EU were to be completed, a minimum increase of 5% was needed compared to the 2013 budget. This would mean that the EU budget would be roughly 1.11% of the EU's total GNI, compared to the 1.06% expected for 2013. The Parliament feared that budget restrictions could jeopardise the already agreed boost for research and innovation (from today's 1.9% of GDP to 3%) as well as investment in infrastructure, foreign policy and enlargement.

MEPs also criticised the current funding system, which relied almost entirely on national contributions and became extremely complex. The EU Treaty says that the EU-budget "shall be financed wholly from own resources" (European Parliament, 2011). They argued that the current funding method placed disproportionate emphasis on net balances between the Member States, contradicting the principle of the EU solidarity, diluting the European common interest, and largely ignoring the advantages of financing policies at the EU level. A system of actual own resources would be "fairer, more transparent, simpler and equitable", said MEPs, whilst stressing that a budget reform does not necessarily have to affect the size of the budget and would not increase the overall tax burden on citizens. They also called for an end to the "rebates, exceptions and correction mechanisms"[67] that have accumulated within the current system (European Parliament, 2011).

According to the European Parliament, another important problem with the current MFF was the lack of flexibility it allowed within annual budgets. If something new or unexpected came up, it was hard to adapt the budget to accommodate the new needs. This was fully consistent with the position of the European Commission that used several examples to show the inability of the EU budget to react to unexpected

[67] Apart from the British rebate, also Austria, Germany, the Netherlands and Sweden have a rebate on the British rebate, they also have lower VAT and national income contributions even though these are lowered only temporarily. The Dutch also benefit from keeping larger share of customs collected in Rotterdam (Peet and Tindale, 2012).

events including economic crises or changing demands in major European projects such as Galileo. MEPs therefore wanted to see a global MFF margin created, consisting of unused margins, de-committed, and unused appropriations from the previous year(s).

## 8.4 Final Outlook of the MFF Proposal and What Next?

The final agreement among the Member States was reached in February 2013 during lengthy and complicated negotiations. The talks started with a six hour delay due to extended bilateral talks and smaller meetings. The Italian Prime Minister held up the talks because of the need to deliver a good deal prior to an election in late February, previously complaining that Italy was the largest contributor in 2011, while many other Member States presented last minute veto threats until minor concessions were granted (Netherlands, Czech Republic, Austria, Romania, Bulgaria) (Pop, 2013a). The hold-up happened despite efforts to pre-negotiate the outcome by president Van Rompuy and also German Chancellor Angela Merkel, who prior to the February Council met with Italian PM, Mario Montti, Spanish PM, Mariano Rajoy, and French president, Francois Hollande. Hollande signalled his will to agree to more cuts if they did not impede economic growth (Pop, 2013b) and declared support for increased structural funds. Hollande was under a lot of domestic pressure: all time low domestic popularity, high unemployment and slow economy at the end of 2012, only saved by the French intervention in Mali, which pushed up his popularity rating. Merkel prior to the meeting with Hollande and despite the German austerity position towards the EU budget declared that the funds allocated to the EU budget were rather small, indicating that she was prepared to play the role of a mediator between the two main groups in the negotiations. As a result, the final outcome was closest to German demands – expenses only slightly higher than what the UK, Netherlands and Sweden demanded. While these three countries cared most about the overall ceilings, the other Member States were more interested in individual headings, which would determine their final net position. As expected, Merkel turned out to be the deal broker, coming to an agreement by advocating austerity and pro-growth measures (Vogel, 2013b).

After 18 hours of talks, the EU Member States approved the following structure of the EU budget for the years 2014–2020. The maximum

expenditure was set to 959.99 billion euro (in 2011 prices) in commitments, i.e. 1% of the EU's GNI for 28 Member States, which means real terms reduction of 3.4% compared with the 2007–2013 framework and the first time ever reduction in overall expenditure compared to previous MFF. The reduction was justified by reflecting "the consolidation of public finances at national level" (European Council, 2013). The ceiling for overall payments was set to 908.4 billion euro (2007–2013 was 942.78 billion euro).

The CAP funds were to be cut from 421 billion euro to 373.18 billion euro and Cohesion funds to be cut from 355 billion euro to 325.15 billion euro. Poorer regions were to receive more than in the 2007–2013 period and a new youth employment initiative was created. CAP and Cohesion, also known as the "backward looking policies" (Vogel, 2013b), saw biggest cuts, 17.5% and 8.4% respectively, but still receive by far the largest sums. More money was earmarked for "competitiveness for growth and jobs", increase from 91 billion euro to 125.61 billion euro (up by 37% compared with MFF 2007–2013), even though still substantially less than proposed by the Commission or even Van Rompuy in November 2012 and still much less than the overall ceiling for CAP and Cohesion.

More money was also allocated for Horizon 2020 and "Erasmus for all" programmes. One of the "victims" was the Commission's "flagship" Connecting Europe plan (proposed 50 billion, earmarked 29.3 billion euro, still 50% increase from current MFF). Within the 29 billion euro was 23 billion euro for transport, 5 billion euro for energy and 1 billion euro for internet. Other initiatives such as Gallileo, ITER, and GMES, got total 13 billion euro allocated (Kirk, 2013). Security and citizenship was allocated 15.69 billion euro for migration, asylum, external borders and internal security. Global Europe received 58.7 billion euro. Additionally, administration expenses were set at 61.63 billion euro. This decrease will mostly affect salaries of the EU employees. As a result, staff will be reduced by 5% and EU employees will work more hours for same money with salaries frozen for 2 years. The savings in administrative costs became an ideological issue for some countries (Sweden, UK, Netherlands) (Mahony, 2013b) and the EP did not question it. Finally, the European Development Fund is to receive 26.98 billion euro. As for national payment reductions, the British rebate is to be maintained, Austria, Denmark, the Netherlands and Sweden will have the reduction of their national GNI contributions. The savings were to be found in some victim areas including.

Much of the deal is believed to have been agreed prior to the summit when the less competitive economies including France agreed to lower the ceiling on spending in return for less cuts for CAP and structural funds. Thus, one of the reason in finding a deal was in "horse-trading" over relatively small amounts (small sweeteners) (Mahony, 2013b), confirming the established notion of every country has to bring something home to declare "victory". In order to add somewhere, they take from elsewhere, that is from lines that do not have strong ideological defenders in favour of lines that are more politically rewarding in the domestic electorate. France will receive 200 million euro for its new overseas territory, island Mayotte; Baltic states will received compensation for low per-hectare subsidies; Northern Ireland will receive money for its peace projects; Lithuania, Slovakia and Bulgaria got more funding for nuclear plant decommissioning; Hungary extra subsidy of 1.56 billion euro and Czech Republic 900 million euro in structural funds; Italy, France, Spain, Slovakia, Portugal and Belgium received larger shares of structural funds due to high unemployment; Spain would also benefit from youth unemployment fund, France from extra farm subsidies; Austria kept its rebate even though only of 60 million euro, Denmark received a rebate it was not entitled to before. As the overall expenses were reduced, this policy of rewarding Member States for support displays the attitude of "robbing of Peter to pay Paul" (Mahony, 2013a). The chair of the EU budget committee, Alain Lamassoure, called the EU budget negotiators "a group of Margaret Thatchers, each one wanting their money back" (quoted in Pisano, 2013), the Italian PM called the meeting "orgy of cuts" (Bydžovská, 2013) and Czech foreign minister said it was based on the saying "accept when they are giving, scream when they are taking" (Euroskop, 2013).

The last issue to address was how to present the agreed deal to the European Parliament, which threatened to veto any cuts to the original proposal of the Commission. The point of the negotiations was therefore to also prepare a proposal that would not antagonize the EP too much. Yet, many MEPs highlighted the Council's narrow focus on national interests noting that the only person speaking up for Europe was president Van Rompuy (Alain Lamassoure in Fox, 2013a). EP President Martin Schultz defined the deal made at the European Council as "the most backward proposal" and the "beginning rather than end of the process" (Fox, 2013b). The clear EP's rejection of the deal in its March session (506 MEPs in favour, 161 against, 23 abstaining) did not, however, question the overall ceiling, just its objectives. The Parliament

requested that the Member States provided 14 billion euro to cover previous unpaid payments, demanded more flexibility for re-allocation of unspent funds, asked for Commission's review in the middle of the MFF if adjustments would be required due to different economic conditions and asked for a new own resource, referring to the FTT. The EP President commented on the vote with saying that the EP would not "accept the proposal from the member states unless there is movement on all these issues" (Vogel and Keating, 2013) even though the Irish Europe minister, Lucinda Creighton, considered this only a strategic move of the EP as it did not want to give up the fight but also did not want to block the budget (Vogel and Keating, 2013) Thus, the amendment of the 2013 budget and new MFF were negotiated together where the latter would renegotiate the ceilings but focus on flexibility, revision clause, own resources and unity of the budget. The EP's less radical stance was apparent already prior to the March vote indicating that many MEPs felt or were under pressure from their countries not to destroy the deal that was so hard to make (Vogel, 2013a).

Yet, the various moves and statements criticising the budget structure indicated the Parliament's will to be taken seriously. Martin Schultz is determined to make the EP a venue for important European debates. This resolution was very clear in his February announcement that the MEPs would hold a secret ballot on the MFF proposal even though in the end this procedure was called off, which probably had a lot to do with the fear of the German MEPs in the European People's Party to publicly oppose a deal struck for a large account on German terms prior to the national election. Together with the EP's increased role in the Lisbon Treaty, it threatened to complicate the ratification process of the MFF. The Parliament was a delicate position – rejecting the February deal would jeopardise many EU programmes including the ones to fight economic downturn and approving it deemed the Parliament irrelevant in future budgetary negotiations because the MEPs felt that they were being given expenditure ceilings as fait accompli. The Parliament faced similar situation in the 1980s, when it chose to use the newly acquired strength to reinforce its situation vis-à-vis the Council. For some, the European Council put itself in this position by first approving increased EP powers in the Lisbon Treaty and second by including details of budget spending in its negotiations instead of leaving that for the negotiations in the sectoral Councils which would not require the consent of the Parliament (European Voice, 2013).

## 8.5 Our Proposal for EU Budget Reform – Financial Perspective 2014–2020

The size of the EU budget which is growing in absolute terms is fixed in its relative size and there is no long-term support to increase it significantly above the 1% of EU GNI despite the support from the European Commission and the European Parliament. However, the recent problem of some Eurozone countries re-emphasized the need to seriously discuss the ability of EU budget to play a stabilizing role as recommended by MacDougal report back in 1977. The MacDougal report (1977) and Sapir report (2003) were not isolated attempts to seriously discuss the increase of relative size of the budget of EU and the reform of its revenue and expenditure sides. The contributions to the reform debate could be divided into three main groups. The first group of studies concentrated on the effectiveness of Common agriculture policy (CAP) and Cohesion policy, arguing for significant decrease of expenditures on CAP (or even its renationalisation) and for significant concentration of structural and cohesion policies only to the poorest regions and member states (Thurston, 2005, Nicoladies, Talsma, 2005, Ferrer, 2007, Gross, 2008, European Commission, 2008). The second group of studies contributed to the debate with an analysis of the relative size of the EU budget and the design of genuine own resources in the form of some European tax(es) (Le Cacheux, 2007, Begg, 2005, Cattoir, 2004). The third group of studies appeared as a reaction to ongoing Eurozone crisis, searching for options to increase the Eurozone's fiscal capacity while creating an adequate federal budget with a stabilization capacity for a fully functioning monetary union (Delpla and von Weizsäcker, 2010, Bordo, Markiewizc, 2011, Begg, 2011, Hallerberg, 2011, Wolff, 2012, Pisani-Ferry et al., 2013).

Given the above mentioned directions of possible reform of EU budget, the negotiations of the 2014–2020 Multiannual Financial Framework (MFF) offered several opportunities and challenges. Firstly, given the very negative effects of the Eurozone crisis, the discussion should have moved from the technical (bureaucratic) point of view to the political one. Most of the former and recent discussions about the EU budget reform had just a technical dimension, i.e. how to move resources between different headings without increasing the size of EU budget and revenues or even how to receive the same results with a lower budget. Given the degree of economic integration (existence of common currency), the discussion required stronger policy oriented tendency and also reflection of the Eurozone problems.

Secondly, given the negotiation process of the future Multiannual Financial Framework (MFF) and the role of EU Council, a serious discussion on the ability of the Member States to agree on a significantly higher ceiling for the EU budget revenues was in place rather than just protecting their net balances and national interests to receive as much as possible in net transfers from the EU budget. The size of the EU budget is not sufficient to provide insurance against negative asymmetric shocks in the Eurozone. The representatives of EU member countries could have opened a political debate on the options for strengthening the Eurozone's fiscal capacity.

Thirdly, given the size of the already agreed funds which were to be provided to the indebted members of the Eurozone, there was a good opportunity to either include those funds into the EU budget framework or to create an autonomous budget for the Eurozone member countries. Such a political decision could increase the stabilization capacity of the EU budget and make it more relevant to given stage of economic and political integration which the EU had reached after the Maastricht Treaty.

Policy makers were to decide between Scylla and Charybdis – either strengthen the principle of solidarity via an increased size of the EU budget with all potential positive but also negative consequences (such as long-term redistribution of resources, i.e. taxes, to "problematic" countries and possible creation of a new "Mezzogiorno"); or respect the recent status quo and continue making technical changes inside the recent structure of budget without any significant move towards a budget which would fit the given stage of economic and political integration. With the new policies and responsibilities in place, the latter option – as seen with the 2012 and 2013 budgets – runs the danger of failing to provide adequate resources to meet the EU's commitments. The lack of willingness to discuss possible federalization of the EU budget leads to the situation when further economic and political integration is limited by an insufficient size of the common budget.

The reform of the European Union budget presents an opportunity for a modification of income, expenditures, and the size of the budget itself. Reform proposals at both expenditure and revenue sides are necessary. Whereas the door leading to the existing expenditure reform was already opened and discussed intensively across the EU, the gap in the door offering possibilities of changes in the budget income and the door protecting the size of the budget are very small. Although it would be suitable to implement changes in all the areas at the same time and in

an interconnected context, particularly expenditure changes can most likely be expected. The reason lies in positive theory of public finance, which stresses role of personal interests of politicians, various pressure groups or aversion of politicians as well as EU Commission officials to big changes and following path dependency instead, making only incremental steps in a new direction.

Whereas Member States could agree with an increase of the common budget expenditures for research and development, trans-European networks or external border protection, some elements of the future EU budget reform – the expenditure side – are much more controversial such as joint expenditures for development aid, defence, stabilisation policy and common agricultural policy. A change of the funding of the common agricultural policy has been widely discussed for many years and most EU countries agree on the need to release EU budget funds allocated to CAP for other purposes. It can therefore be considered as the most realistic although there will surely be animated discussions between the proponents of exclusive and generous funding of CAP from the EU budget and its opponents. Pressure groups have always been very effective in assertion of their interests concerning this policy, which together with the path dependency argument might lead to only gradual move to national co-financing of the market related expenditures and direct aids since 2014.

Also the proposal to increase the role of the EU budget in the financing of development aid is not entirely unrealistic as it has its proponents in both the European Parliament and Commission and in addition, it offers substantial advantages due to the reduction and simplification of aid administration, better coordination, economy of scale and synergy effects of the joint use of the development funds. Pressure for a lower degree of transfer of development aid funding to the EU budget can be expected. As regards the proposal for the joint funding of EU defence, it is in this policy that, besides the internalization of externalities, there is the biggest potential of economies of scale, and it would certainly be worth of at least open discussions of the joint funding of relatively less sensitive military expenditures related to military equipment procurement and military research and development. Participation on financing of these expenditures can be acceptable also for the EU neutral states since it does not bind them to participate in any common military operation. The focus on foreign policy, especially its neighbourhood policy dimension, has been accentuated by the effects of the Arab spring. Re-

lated to that is the issue of migration and preservation of Schengen zone through strengthening external borders.

The EU stabilisation policy could be based on the European Unemployment Fund that would provide financial assistance in the form of specific-purpose subsidy requiring co-financing to Member States whose regions are hit by unemployment higher than the EU average. Establishing this instrument, which is discussed also in works of many authors (see MacDougall, 1977, Dullien and Schwarzer, 2007, ECORYS, CPB and IFO, 2008) might face opposition from Member States' governments since it touches their national employment policies that are still considered as highly sensitive matter. On the other hand, this instrument would not involve any harmonisation of these policies; it would just provide assistance to national budgets to ease the fiscal burden connected with payments of higher unemployment benefits. Nevertheless, if this instrument is unacceptable for national governments, they could possibly agree on at least increasing the scope of the current European Globalisation Adjustment Fund.

In the end, there can be a completely different reason that will make the proposed changes of the EU budget expenditures unrealistic – its size. The higher size of the post-reform budget in terms of EU-27 GDP, will surely lead to resolute rejection in number of countries, as the mantra of many European governments in relation to the EU budget has been 1% of GNI. Although it is only about a transfer of expenditures from the national level to the supranational level that would not mean an absolute increase in public expenditures but only their centralization aiming at a reduction of the total volume of expenditures due to better coordination and reduction of duplicate expenditures, from the Member States' perspective such a change would primarily mean a transfer of powers and sovereignty from national to EU institutions.

It might therefore be expected that the limit will be set close to 1% GNI and the discussion on structure and size of individual expenditure items will be based on that. The reformed EU budget expenditures will consequently reflect either an increase in the European Union competences or will only be a result of allocation transfers between the current policies. In such a case, development aid and defence policy in the proposed extent would probably not appear among expenditures (in the case of development aid only to a limited extent or possibly also with the incorporation of the European Development Fund expenditures). In any case, it still enables the implementation of all the other expenditure changes

towards a modern supranational budget that will perform allocation, redistribution and stabilization functions and support the competitiveness of the European Union by funding expenditures with European added value. Finally, one more important factor will be stressed in the EU budget reform discussions: impact of the reforms on the budgetary balances of Member States.

Given the size of the EU budget and the size of European stabilization mechanism, we can calculate what would be the new ceiling for the EU budget revenues in the financial perspectives starting in 2014. The estimated volume of financial instruments already used or reserved for help to indebted countries until June 2013 within ESMS and ESFS and after June 2013 within ESM is equal to 1.5% of EU GNI. If we include those instruments inside the EU budget with the aim of improving its stabilization function, the EU budget ceiling for revenues will rise up to 2.5% of EU GNI, in other words, it will increase accordingly the ceiling given by the decision of the EU Council for financial perspective 2007–2013 by 150%.

## 8.6 Conclusions

Even though Council President Van Rompuy called the proposal "balanced and growth-oriented" based on "sense of collective responsibility from Europe's leaders" and labelling it as "future-oriented", "realistic", and "driven by pressing concerns" (European Council, 2013) it failed to indicate a will to move away from juste retour to a more Europe-oriented budget plan. The Eurozone debt crisis could have been used as an opportunity to improve stabilization capacity of the EU budget but for the time being, this window closed because a majority of Member States in the negotiations continued to focus on national interests and their net benefit even though hiding behind European interest rhetoric, which allowed to manoeuvre through the negotiations. The current crisis provided the pro-reform actors with extra leverage but agreeing on the need to reform did not mean knowing or agreeing what and how to reform. Change was possible if main three actors' positions opened to the following: CAP reform possible under Hollande in exchange for Britain agreeing to end the rebate and Germany allowing more spending but on the previously declared but neglected categories, i.e research and development, education, energy, climate change. Another chance was facing very difficult negotiations; just like the crises in the 1980s led to

a significant reform, so we were facing another opportunity here – make the negotiations so hard that the "game" would have to change because the actors would not want to go through it again. Such situations did not materialize and so the reform potential was missed.

Taking in account the dynamics of Eurozone crisis and reactions of EU and Eurozone institutions there are two potential strategies for future reform of EU budget. The first one is to move the whole EU more closer to final stage of integration – political union (fiscal union) and in line with this to increase significantly the size EU budget. The second one follows the two speed Europe development. There will then be space for two budgets strategy. One budget in recent form will be for the whole EU providing mainly allocate and redistributive function mainly through structural and cohesion policy complemented by increased expenditures on research, development and pro-growth incentives. The second – Eurozone budget – providing the stabilization function for countries which are hit by asymmetric shocks. The Eurozone budget then will be created based on political decision of Eurozone member countries to follow the path of closer cooperation in fiscal area which was already started by implementing fiscal pact and decision to complete banking union.

However there is a significant assumption for both strategies. Both strategies towards reforms of the spending programmes and increasing the size of EU budget will depend on the willingness of citizens to allocate additional tasks to the EU and thus may only be realised as a consequence of changes in the degree of political integration. As Padoa-Schioppa (2002) puts it: *"There can be no doubt that it would be a good thing, for the Union, to have more room for manoeuvre in the area of budgetary policy. But it is also my belief that this can only come as a natural consequence of political union. No country has ever adopted a large budget just in an effort to obtain more instruments for economic policy. Historically, the size of the budgets grew because the functions attributed to the Union grew."* Even by increasing the EU budget by 150% up to 2.5% of EU GNI, it will be still significantly lower than comparable federal budgets and even marginal proportionally given the redistribution within national budgets. The Eurozone debt crisis could be used as an opportunity to improve stabilization capacity of the EU budget.

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# 9 Euro Crisis: Economic Efficiency Versus Morals

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## 9.1 Introduction

The European crisis has entered the phase where the possibility of euro break-up is at the table. The supranational institutions including IMF, European Commission and ECB (so called Troika) are trying to avert uncontrolled melt-down. Their representatives usually believe their mission is to find and pursue solutions that reduce the risks and the costs to the minimum, while maximizing future benefits from the point of view of the creditor countries[68]. Underlying to that approach is the assumption of moral attitude of maximum gain and minimum pain. That is classical utilitarian attitude introduced first by Jeremy Bentham (Storig, 2007). Although that kind of moral attitude is understandable, given tremendous costs of eventual euro break-up, it is not the only way people assess and understand "what is the right thing to do". We argue that current policy of Troika ignores several conflicting moral attitudes that are hidden beneath classical utilitarian point of view. If Eurozone aims to re-transfer itself into fiscal and political union, institutions can hardly ignore the conflicting morals in the long-term.

In Section 9.2 we demonstrate the view of Troika as a defender of creditor countries such as Germany. Its ultimate effort in the current crisis is to maximize the volume of peripheral external debt that can be repaid to the creditors. Therefore in the first part we focus on typical creditor country[69] – Germany. First we try to show that debt sustainability analysis, which creditor countries perform for the peripherals, is

[68] One can imagine utilitarian advocacy from both the creditor and the debtor side. Nevertheless historically the IMF, whose know how is essential in current euro crisis management, used to advocate the creditor countries. In depth analysis of the historical development of IMF is provided among others by Woods (2007).

[69] By creditor country I understand the country with significant and persistent current account surplus. I do not consider the government budget balance a decisive criteria to distinguish creditor and debtor. Public balance reflects only the position of one sector (public) and not the whole economy (mainly financial sector and house-

extremely sensitive to initial assumption. So creditors cannot be sure in advance about the adjustment trajectory of peripheral economies. But the decision to finance the adjustment process once made, offers a hope, that most of the peripheral debt may once be repaid back. On the other hand, we demonstrate that the decision to stop funding the peripheries is connected with immediate significant costs. We conclude that from utilitarian point of view, it is not rational for Germany to opt out of Eurozone. Hence any scenario, under which the Germany pushes for euro break-up, should assume coordination or behavioral failures of the politicians.

In Section 9.3, page 196, we try to argue that it can be challenging for German politicians to advocate Eurozone survival policy solely on the utilitarian basis – the threat of more costly alternatives. Several competing theories of justice would disagree[70]. Their proponents might correctly argue that (economic and social) consequences are not all we care about, when we are judging moral legitimacy of actions and policies. Those arguments against utilitarianism dates back at least to Immanuel Kant. We elaborate on Kant's objection against utilitarianism and try to explain, why people from surplus countries such as Germany can theoretically abandon transfers to the peripheries, even if they economically turn worse off. My ultimate point is that economically inefficient euro break-up can be chosen by democratic societies such as Germany without any coordination or behavioral failures, but solely due to the inability to deal with a problem as a moral one.

## 9.2 The Cost of Euro Break-up for Creditors

We now try to examine the position of the creditor countries from pure utilitarian point of view – such a one in which countries maximize potential gains and minimizes potential costs. From that point of view the creditor country – such as Germany – should try to maximize the share

holds are ignored). By the position of the country I understand the position of overall economy – sum of external positions of all sectors. Behind the logic of calculating the debt sustainability analysis for the overall economy lies an assumption of certain degree of risk sharing among individual sectors within the economy. If the banking sector is in troubles, one would assume it to be at least partially bailed out by the government. If the government is in funding troubles, one would assume the banking sector to support it via government debt or T-bill purchases as we have seen in Greece during the period 2010–2012.

[70] The major criticism of utilitarianism stems from the workings of Immanuel Kant. See Sandel (2010).

of debts that can be repaid back from peripheral countries. For that purpose the Troika carries out regular debt sustainability analysis that shows, whether the program is on track or whether it pays off to provide additional funding to the peripheral economy[71] or whether the peripheral debt needs to be restructured. From a point of view of the creditor country it pays-off to provide further funding to the periphery and thus keep it in Eurozone,[72] if the additional transferred funds increase the probability of the overall debt being paid back.

Although that kind of logical judgment is pretty straightforward and easily understood, in reality it is not so easy to perform it. Debt sustainability analysis requires decision on several interdependent and highly uncertain assumptions. Among crucial are growth rate of peripheral economy, realistic primary surplus target for current account and the time period that the core country such as Germany is willing to finance the adjustment of periphery. Analysts enter highly uncertain scenario exercise, where the outcome is extremely sensitive to the initial assumptions that are at least partly based on what you tend to believe in.

Let's look at imaginary case of deficit country D and its debt sustainability analysis. From a scenario analysis below, one can see that relatively minor changes in assumptions lead to significantly different outcomes. In 20-years horizon the foreign debt to GDP ranges from 120 to 270% of GDP based on minor changes in the assumptions. Let's assume there is a single surplus country S that is about to decide, whether to continue finance the current account deficits of the country D. If it decides to stop funding it, we assume the country D to default on the foreign debt with the recovery ratio of 30%[73]. Hence the surplus country S immediately records a loss of 105% of GDP of country D. If S continues to finance D,

[71] The funding can take several forms. In case of Eurozone it can be loans to national governments from rescue mechanism ESFS or ESM. It can also take form of ECB programs such as SMP or OMT that help national governments with the liquidity on the secondary bond market. Furthermore growing exposure of ECB towards peripheral banking sector is also a form of funding assistance to the peripheral economies (either via covering balances in the Target 2 or via operations such as LTRO).

[72] Countries with significant current account deficits or external debt redemptions need access to foreign liquidity. Otherwise their financial sector dries up, and the banks as well as government may be pushed to pay its claims not with cash but with new debt notes. These new debt notes can establish as a second currency in circulation.

[73] The recovery ratio is uncertain, however in case of unmanaged sovereign and external defaults, such as in case of Argentina 2002, usually the recovery ratios are very low, even below 30%. For further evidence see Reinhart, Rogoff (2009).

| **Scenario Summary** | **Best** | **Worst** | **Base** |
|---|---|---|---|
| **Variables** | | | |
| **Initial foreign debt to GDP – *D*** | 150% | 150% | 150% |
| **Initial current account balance – *b*** | –6% | –6% | –6% |
| **Duration of current account adjustment** | 3 | 7 | 5 |
| **Target current account balance – *b*** | 4% | 2% | 3% |
| **Interest rate on foreign debt – *i*** | 3% | 3% | 3% |
| **Duration of transitional recession** | 4 | 7 | 5 |
| **Growth at the bottom of recession – *g*** | –3% | –6% | –5% |
| **Normal growth rate (after recession) – *g*** | 3% | 1% | 2% |
| **years** | | | |
| **1** | 165% | 170% | 169% |
| **2** | 175% | 190% | 184% |
| **3** | 180% | 207% | 197% |
| **4** | 176% | 222% | 205% |
| **5** | 172% | 235% | 206% |
| **6** | 168% | 245% | 205% |
| **7** | 164% | 249% | 204% |
| **8** | 160% | 252% | 203% |
| **9** | 156% | 255% | 202% |
| **10** | 152% | 258% | 200% |
| **11** | 148% | 261% | 199% |
| **12** | 144% | 264% | 198% |
| **13** | 140% | 268% | 197% |
| **14** | 136% | 271% | 196% |
| **15** | 132% | 274% | 195% |
| **16** | 128% | 278% | 194% |
| **17** | 124% | 281% | 193% |
| **18** | 120% | 285% | 192% |
| **19** | 116% | 288% | 191% |
| **20** | 112% | 292% | 190% |

**Table 15 Scenario analysis of external debt development**

Notes: I assume same initial foreign debt, current account deficit and interest rate on foreign debt under all three scenarios. Interest rate on foreign debt is stable as I expect the transfers from credit countries to keep the cost of financing at unchanged level. Changing variables include duration of current account adjustemnt and target current account surplus that the deficit country can reach as well as duration of transitional recession and perspective for long-term growth. I expect the economy to have the most dramatic fall in first year and subsequently linearly adopts to its long-term growth target.

Source: Author.

let's assume one of the three scenarios materialize – the best, the base or the worst. It is evident that in the best case scenario, for a surplus country S, it pays off to finance the adjustment process of the deficit peripheral D. On the other hand, it is clear that in a worst case scenario, when the foreign debt never stabilizes, it does not makes sense. In base case, the extension of financial assistance also pays off. However a surplus country must be willing to finance the periphery for longer term as initial decline in GDP is deeper and deterioration of debt to GDP ratio more pronounced. This abstract example reveals two important characteristics of the dilemma that a typical creditor country is facing. First of all, the future debt trajectory and ultimate debt burden of the periphery remains always highly uncertain. Second, when the creditor country decides to stop funding the periphery, it incurs immediately substantial costs.

Calculation of foreign debt trajectory:

$$D_t = D_{(t-1)} \cdot \frac{1+i}{1+g} - b \tag{7}$$

We can look now more specifically on the position of Germany towards European peripheral economies. The overall exposure of German financial system towards peripherals exceeds 1 trillion of euro[74] and continues to grow as peripheral countries are still in process of external adjustment (see Figure 15). So If we assume about 30% recovery ratio, German financial system would incur immediate loss from the exit of these peripheries around 700 billion euro.

The adjustment process of the peripheries, as we have explained above, is always highly uncertain. Nevertheless we can look at the anecdotal evidence of the progress made since the start of the crisis. As Table 16 shows, current account has significantly improved since Q3 2008[75] and is nearly balanced across the major peripheries.

Furthermore we can apply transformed Equation (7) from the scenario analysis above to calculate target current account balance needed to stabilize foreign debt. We assume that the financing is provided for deficit countries at average interest rate of 4%. Under that assumption the target current account balance to stabilize external debt has already nearly

[74] We consider exposure towards of German financial sector towards Greece, Portugal, Spain, Ireland and Italy. We ignore direct exposure of German Government, households and non-financials.

[75] Fall of Lehman Brothers.

**Figure 15 German exposure to peripherals**

Notes: Exposure of German Financial Sector.
Greece, Ireland, Portugal, Spain, Italy, TARGET 2 (billions euro)

Source: Thomson Reuters Datastream, Fathom Consulting.

| % of GDP | Current Account | |
|---|---|---|
| year | 2008 Q3 | 2012 Q3 |
| **Italy** | −3.4 | −0.5 |
| **Spain** | −9.1 | −0.4 |
| **Greece** | −15.5 | −0.7 |
| **Portugal** | −13.6 | −0.7 |
| **Ireland** | −8.1 | 5.4 |

**Table 16 The progress in current account adjustment**

Note: Eurostat Data seasonally adjusted with X12 ARIMA.

Source: Author.

been reached across the peripheries. See the calculations in Table 17 (Equation (8)).

Calculation of target current account balance:

$$b = D_{(t-1)} \cdot \left( \frac{1+i}{1+g} - 1 \right) \tag{8}$$

As far as now only restructuring of 106.5 billion euro of Greek sovereign debt has taken place and according to EU banking stress tests (Blundell, Slovik, 2010) the share of costs to the German banking sector was approximately 9.4 billion euro.

Hence the choice the German policymakers are facing is whether to continue to bet on further adjustment process of the peripheries that has cost the German financial sector approximately 9.4 billion euro. Or alternatively decide to stop the peripheral funding, push the peripheries out of the Eurozone and record immediate loss around 700 billion euro.

Although the adjustment process is highly uncertain (one could easily question especially the assumptions of normal growth rates in Table 16), it is clear the external position has already improved significantly and we are not far from target current account balances needed to stabilize the foreign debt. Hence the chance that many peripheries can avoid further restructuring is growing and rational policy-makers would hardly opt for immediate massive default on foreign debt connected with eventual euro break-up. Furthermore, as some authors point, the decision to stop funding the peripheries and break the Eurozone would incur other costs than immediate write down of significant portion of the external debt. Deo and Donovan (2011) for example point to the costs associated with the reinstallation of border controls or the control of capital account.

| % of GDP | Initial foreign debt | Interest rate on foreign debt | Normal growth rate | Current Account target | Current account actual |
|---|---|---|---|---|---|
| year | D | i | g | b | 2012 Q3 |
| Italy | 53.4 | 4.0 | 1.3 | 1.4 | −0.5 |
| Spain | 93.4 | 4.0 | 3.5 | 0.5 | −0.4 |
| Greece | 114.4 | 4.0 | 3.5 | 0.6 | −0.7 |
| Portugal | 92.1 | 4.0 | 1.9 | 1.9 | −0.7 |
| Ireland | −379.2 | 4.0 | – | – | 5.4 |

**Table 17 Target current account balance to stabilize foreign debt**
Source: Eurostat.

Hence we can make a conclusion here that judging purely from utilitarian point of view, further transfers to peripheral economies and preservation of Eurozone makes sense for the creditor countries such as Germany.

## 9.3 The Moral Dilemma of Creditors

Nevertheless defending further transfers to the peripheral economies can be challenging from other than pure utilitarian reasons. My central point in the second part is that the monetary, fiscal and subsequently political union cannot rely in a long-run only on the pure utilitarian argument: fear of too costly euro break-up.

Utilitarian's assume the morality consists only of weighing costs and benefits. According to Jeremy Bentham, father of utilitarianism, the highest principle of morality is to maximize the overall balance of pleasure over pain. That is the typical moral position behind the debt sustainability policy of IMF. Its ultimate goal usually is to maximize the amount of debt that can be repaid to the creditor country – hence maximize the utility function of creditors.

The problem is that people do not always understand morality in that way. Most critics of utilitarism usually date their arguments back to Imanuel Kant. What is common to Kant and variety of his followers is the assumption that people should not care only about the consequences of their actions, but certain duties should be respected universally – regardless of the social or economic consequences.

American Political philosopher Michael J. Sandel (2010) gives nice example that demonstrates the conflict of utilitarianism and other theories of justice. In 1984 four English sailors shipwrecked and stayed in the lifeboat in the southern Atlantic. After four days they ran out of food and water. The least senior of them (cabin boy) started to drink sea water and became seriously ill. On the fifth day the captain Thomas Dudley realized that if they do not see the ship today, they are all going to die. Hence he decided to kill the cabin boy and the three remaining survivors started to eat his body and drink his blood. Approximately twenty days later ship finally appeared and they were all rescued.

From purely utilitarian point of view the decision of the captain to eat the cabin boy was right. Three lives were saved and the alternative option was to lose not one, but four lives. Notice also the moment of uncertainty in decision making that is typical for many decisions based on utilitaristic

assumptions. Captain Dudley had not known that they would have been finally rescued. His decision was a choice between immediate death of all four sailors and a hope for survival of three of them. There are similarities with today's decisions about the financial assistance to the peripheral economies. As we have demonstrated the debt sustainability analysis is highly uncertain exercise and you can never be sure about the final social consequences and ultimate outcome. The choice is between immediate tremendous costs of euro break-up and hope for majority of the external debt being finally repaid.

Nevertheless not everyone believes it is right decision to kill the cabin boy to save the three other sailors. Some might argue that certain actions (such as killing human beings and eating them) are inappropriate no matter what the final consequences of our decision are. In other words the morally right decision would be to wait for rescue till eventual death of all four sailors. Imanuel Kant argued that utilitarism cannot be base for moral action as the future consequences of our actions are always uncertain and hence the moral attitude would become easily arbitrary. Kant connects morality to freedom and argues that people are free only when they do not constantly react and optimize their behavior based on changing external conditions and assumptions of future scenarios of my actions. I am free only when my will is determined autonomously, by rules and laws I give myself. This law can be for example – never kill and eat other human being. Or if we look back to the euro-crisis – never award people that cheated on you and did not play according to the rules. This could be easily brought on the table in case of Greece that constantly cheated on budget statistics prior to 2010[76]. What Kant would advice to do is to follow initially set principles no matter what are the consequences – four people can die, five countries may exit Eurozone and start new world wide depression, but to remain free and morally consistent, that should not change our decision. Although approach of Imanuel Kant and his followers to justice is often criticized (see for example McIntyre, 2011), his original criticism of utilitarism remains widely accepted.

Even though the utilitarism has been overcome among philosophers, it remains influential in everyday life and politics. It is evident that Eurozone and IMF currently follow utilitarian reasoning of what is the right thing to do in peripheral economies. The debt sustainability analysis

[76] In 2009 country's budget deficit was revised upwards from 6% of GDP to more than 12% GDP.

made by IMF lies in the heart of Troikas assessment about further financing to the peripheries. There is scarcely any other dimension of assessment. One could argue that Greece, If taken as a member of family, could be assessed not only based on expected outcome and costs, but on its efforts – the Greek economy is in recession for the fifth year in a row and unemployment has climbed from 7% in 2010 to 26%. One could argue it is just to reward Greece for its effort regardless of the expected trajectory of its external debt. On the other hand some people, as we have already mentioned, might argue that Greeks were cheating and they do not deserve any solidarity no matter what might be the costs of immediate Greek bankruptcy. We do not have the ambition to resolve that dilemma. My point here is that the dilemma is in its essence a moral one. The utilitarism reduces several dimensions of the problem and ignores the natural uncertainity about the future outcome (external debt trajectory) that no one has precisely under direct control and no one can be called responsible for.

Long-term pursuing of utilitaristic reasoning with uncertain ends leads to moral flexibility from a Kantian point of view. One can see that so many principles that the EU had set aside – never breach 3% GDP deficit rule, never directly finance government or banking sector – have already been breached recently in the name of Eurozone survival. That kind of moral flexibility can be in place for some time, but the ignorance of other than utilitaristic reasoning cannot last for ever.

If the moral flexibility is practiced for longer time, the society may start to call for other than utilitaristic reasoning. Let's assume this imaginary situation: It is year 2015 and German Chancellor is asking Bundestag to adopt Greek rescue package number eight. The reasoning behind would sound like that – "we know that Greeks initially cheated and then several times failed to implement agreed reforms, but it is still cheaper for us to keep them in Eurozone than to eliminate negative spillovers from Greek euro-exit".

One could imagine that German society may reach the point, where most of the people would consider the right thing to do from other than pure cost-benefit perspective. Than one could also easily imagine Germany or other surplus country to choose euro break-up, even when the costs may remain at thrilling high levels and the adjustment process of the peripherals have already progressed significantly. What is important to stress that this choice can be made without any coordination or behav-

ioral failures, but solely because the public opinion and policy at certain point turned to different than utilitarian dimension.

## 9.4 Conclusions

We tried to demonstrate that economically inefficient abolition of funding to peripherals, potentially connected with euro break-up, can be chosen by democratic societies without any behavioral or coordination failures. We explain how the attitude of Troika – maximize the volume of external debt that can be repaid to the creditors – can be rejected by a creditor countries even if it is economically inefficient. The reason does not have to be coordination failure, but pure switching off the utilitarian reasoning. As we tried to prove, the problem of help or not help the peripherals cannot be reduced to utilitaristic dimension due to at least two reasons. First of all, people do not care only about the consequences of their actions, but believe that certain duties should be respected regardless of the social and economic consequences. Secondly, the adjustment process of peripherals is always highly uncertain due to the complex relationship among the variables included. Hence moral attitudes based on debt sustainability analysis can become easily arbitrary.

If Eurozone aims to re-transfers itself into political Union, the policymakers can hardly ignore the dilemmas that are in essence moral. The utilitarian argument that euro break-up is too costly may lose its appeal in longer term. British journalist Norman Angel, published in 1909 bestseller called Europe's optical illusion[77]. The central thesis of his slim volume was that the commercial and financial linkages between countries are now so extensive – that no rational country should start a war. He was proved to be sadly wrong as was his pure utilitaristic reasoning.

[77] See Ahamed, L. (2009).

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# 10 Fiscal Compact: Run Away from Lawyers?

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## 10.1 Introduction: EU Law at Wake of 2010–2012 Eurozone Crisis: Unprepared but Flexible

Eurozone crisis of 2010–2012 was not only a crisis of the EU economic governance but also a period when the credibility and coherence of the EU legal system was seriously challenged. The European Union was ill-prepared for the Eurozone crisis, not least from the perspective of the EU law. Not only the Lisbon Treaty contained only a very limited and vague tool-box for potential EU's reaction but the EU law even established rules with the potential to limit freedom of the EU's institutions or member states' intervention into the crisis.

The most notorious EU norm limiting the discretion of the EU decision makers was the famous "no bail-out" clause in Articles 123–125 TFEU which excluded mutual general financial guaranties between the EU and member states and banned the EU and/or members from preferential access to financing their debts by the ECB or national central banks. However, the EU legal framework proved to be sufficiently flexible to enable the EU to turn into major negotiation platform of the financial assistance to the indebted Eurozone states; also the "no bail-out" clauses has not proved to be robust enough to prevent the ECB from transformation into one of the most important actors of the whole process.

The hostility of the EU law to wards financial assistance to Eurozone states was not absolute and the Lisbon Treaty (and predecessors thereof) contained also several "positive" clauses with a potential to justify EU action. From the interventionist's perception, the most "helpful" clause of the Lisbon Treaty proved to be Article 122, paragraph 2 TFEU which authorized the EU to grant financial assistance to a member state facing *"serious difficulties caused by natural disaster or exceptional occurrences beyond its control".* What was even more important was the fact that the Article 122 TFEU did not explicitly excluded its activation in a situation when the members state requesting the EU's assistance contributed to its "serious difficulties" by its own previous behavior.

## 10.2 EU's Reaction in a Nutshell: Legal and Institutional Improvisation

The first reaction of the Eurozone elites to the 2010–2012 crisis was based on a very flexible interpretation of the EU law (treatment of "no bail-out" clause), in combination with the institutional and legal improvisation within (EFSM) or on the margins of the EU legal framework (Greek package, EFSF). In the later state, this creative interpretation and improvisation was complemented by more future oriented changes of the EU legal system which obtained relative orthodox form in some cases ("six-pack") while the legal improvisation survived elsewhere (Fiscal Compact).

As mentioned above, the EU's reaction to the crisis of Eurozone formed a patchwork of EU and quasi-EU actions and initiatives which were only very loosely connected to each other. For instance, the financial assistance to Greece, agreed in spring 2010 and usually labeled as the "Greek Loan Facility", was based on a bundle of bilateral loans between Greece and other Eurozone states where the EU served primarily as a negotiation and coordination platform while (some) EU institutions were involved into the monitoring of the Greek compliance with the loans' conditionality ("Troika" composed of representatives of the European Commission, the ECB and the International Monetary Fund).[78] This "coordinated bilateral loans" format of the Greek Loan Facility also explains why Slovak 2010 decision not to participate[79] caused bitter comments in the other Eurozone states but did not endanger the essence of the financial assistance to Greece.

[78] The package of bilateral loans to Greece was connected by two agreements adopted in May 2010. The first one was an inter-creditor agreement harmonizing the conditions of the loans to Greece, such as participating states' contribution to the whole Greek Loan Facility and the principle that individual loan trenches would be released only after the other Eurozone states unanimously agree that Greece complied with the conditionality of the financial assistance. The second coordinating tool of the Greek Loan Facility was an agreement between the creditors and Greece on the content of the conditionality of the Eurozone financial assistance, including the acceptance of the role of "Troika" in the monitoring of the whole process of the conditionality compliance. See Gregorio Merino (2012, pp. 1616–1617).

[79] Slovak governmental led by SMER Party politically committed to participate in the Greek Package but intended to formally implement the bilateral loan only after the planned parliamentary elections in Slovakia. When the opposition parties that heavily criticised SMER's support for the Greek Loan Facility in the election campaign won (rather surprisingly) the elections and formed new Slovak government, they were not in position to ignore their pre-election rhetoric and were "forced", by public opinion, to revoke Slovak support for the Greek Package.

Almost at the same time as the Greek Loan Facility was formed, the EU elites agreed upon two other instruments of the financial intervention, the European Financial Stabilization Mechanism (EFSM) and the European Financial Stabilization Facility (EFSF), with radically different legal and institutional bases. EFSM and EFSF were not "tailored" to problems of Greece but were drafted in such a way that they could be, theoretically, used by any EU/Eurozone economy in financial difficulties. However, the EFSM and EFSF did not share the same legal and institutional design. The EFSM was created by a Council regulation adopted upon Article 122, paragraph 2 TFEU (mentioned above) while the EFSF was established by a specific inter-state agreement of Eurozone states which created a specific entity ("special purpose vehicle") under Luxembourg law; with Eurozone states as the exclusive share-holders.

Within the EFSM, the activation of the financial assistance was subject to agreement, by qualified majority, within the Council of the EU, and only on the proposal by the European Commission; the beneficiary of the assistance could be any EU state. In contrast, the EFSF assistance could be launched by decision of the EFSF share-holders, i.e. Eurozone states, without formal intervention of the Commission or the EU states outside the Eurozone. Legal differences between the EFSM and the EFSF influenced also the flexibility of their modification in the future – while the EFSM can be changed by a simple amendment of the respective regulation, i.e. without need of ratification, a substantial change of the EFSF, such as increase of its lending capacity, requires modification of the founding inter-state agreement, including ratification process in the Eurozone states which, as demonstrated by Slovakia in 2011, can be a rather adrenaline event.

Due to the vagueness of the original text of the Lisbon Treaty, all elements of the EU reaction (Greek Loan Facility, EFSM, EFSF) faced a risk of being declared incompatible with the EU primary law. With the objective to provide a more solid legal basis for the financial intervention(s), the March 2011 European Council agreed to amend the Lisbon Treaty by inserting a new paragraph, stating that *"the Member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the Eurozone as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality"* into Article 136 TFEU. There still remained a space for legal uncertainty since the Lisbon Treaty amendment required ratification in all EU-27 states but the ratification process started rather smoothly with aim to be completed by

the beginning of year 2013[80]. With the perspective of the new explicit legal base for existence of the EU's assistance mechanisms in primary law, the Eurozone states adopted another international treaty establishing the European Stabilisation Mechanism (ESM), having a format of a permanent international organization seated in Luxembourg (in contrast to the temporality of the special business entity of the EFSF), in February 2012.

In contrast to legal improvisation during formation of the Greek Loan Facility, the EFSF and the ESM, the reform of the Stability and Growth Pact (SGP) was implemented by means of standard EU secondary legislation when the European parliament and the Council adopted five regulations[81] and one directive[82] (or amended older version thereof), labeling the whole legislative package as "six-pack". However, even the SGP reform did not escape unorthodox legal measures. To enhance the complexity and the political profile of the SGP reform, two specific "umbrella" instruments complemented the "six-pack". The first one was the "Euro Plus Pact" which was, rather conventionally, contained in conclusions of the European Council. It was the second instrument, the Fiscal Compact (formally named "Treaty on Stability, Coordination and Governance in Economic and Monetary Union") that invoked the spirit of legal improvisation into the European scene again. The original plan of the Eurozone members, supported by the Council's Legal Service, was to adopt another amendment of the Lisbon Treaty with opt-outs for those non-Eurozone states objecting new Compact's rules. It was

[80] In autumn 2012, all EU states completed the parliamentary ratification/assent procedures but the final royal or presidential assent was still being awaited in several EU countries in October 2012. European Parliament – Directorate General for Internal Policies. Article 136 TFEU, ESM, Fiscal Stability Treaty. Ratification requirements and present situation in the Member States. Brussels 2012.

[81] Regulation (EU) No 1173/2011 of the European Parliament and of the Council of 16 November 2011 on the effective enforcement of budgetary surveillance in the Euro Area, regulation (EU) No 1174/2011 of the European Parliament and of the Council of 16 November 2011 on enforcement measures to correct excessive macroeconomic imbalances in the Euro Area, Regulation (EU) No 1175/2011 of the European Parliament and of the Council of 16 November 2011 amending Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, Regulation (EU) No 1176/2011 of the European Parliament and of the Council of 16 November 2011 on the prevention and correction of macroeconomic imbalances, Council Regulation (EU) No 1177/2011 of 8 November 2011 amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure.

[82] Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States.

only after failure to reach consensus of all EU states, needed for Lisbon Treaty amendment, when a plan to adopt a Fiscal Compact in form of a separate international treaty with specific ratification mechanism[83], only vaguely linked with the EU treaties, emerged and was consequently supported by 25 EU states[84].

## 10.3 Legal Controversies of the EU Action(s)

When the French minister of finance (later appointed as managing director of the International Monetary Fund) Ch. Lagarde was asked, in December 2010, by a journalist about the legality of EU bail-outs, she accepted that she and her ministerial colleagues in the Eurogroup *"violated the rules because* (we) *wanted to close ranks and save the Eurozone"* (Leigh, 2010). This should not be interpreted as a sign of total legal nihilism among the EU elites. In contrast, the EU institutions and the member states usually expressed the opinion that their actions are fully compatible with the EU law, if not necessarily with the details of the specific norms then at least with the more general principles and spirit of the European integration project. For instance, the compatibility of the Fiscal Compact with the EU law should be "guaranteed" (or at least strengthened) by combination of a general clause on compatibility of Compact's measures with the EU law and frequent references to existing or expected EU secondary legislation necessary for efficient functioning of the Compact (Lenfeld, Přenosil, Nedvídková, 2012, pp. 80–81). These rhetoric attempts to tackle problems of legal compatibility do not, however, hide the fact that many of the EU/Eurozone measures during the crisis triggered significant legal concerns (Ruffert, 2011, p. 1785). Legal controversies of the EU/Eurozone's action include the issue of by-passing the "no bail-out" clauses, the plan to use the EU's institutional capacities by mechanisms adopted outside the EU's framework, a de facto amendment of the EU's procedural rules by the Fiscal Compact, (dis)respect to the principle of conferred powers by the conditionality of the financial assistance and, last but not least, a possible collision with the EU's obligation to respect the constitutional identities of member states.

[83] For the Fiscal Pact to enter into force, ratification by 12 states is sufficient. This is in sharp contrast with general rules on amendment of the EU primary law where ratification by all EU states is required.

[84] For details on the negotiation leading to the Fiscal Pact, see Belling (2012, pp. 18–20).

The first challenge to the EU decision-makers was the legal justification of a political decision to financially assist several Eurozone states in light of the "no bail-out clause" in the Lisbon Treaty, banning privileged financing of member states' debts from the EU or quasi-EU resources. Originally, the EU/Eurozone financial intervention tried to avoid this restriction by stressing the "non-concessional" character of the loans; in particular, the fact that the loans are not interest-free. Even an interpretation emerged that the requirement of "no co-responsibility" (as phrased in Article 125 TFEU) does not imply "no assistance" as practiced in 2010–2012 (Louis, 2010, p. 983) bail-outs or even that the use of Article 122, paragraph 2 TFEU automatically prevents clash with the "no bail-out" clause.[85] However, this narrow interpretation of the "no bail-out" rule ignores the fact that the "concessional" character of the loans could be based not only in the level of interest rates but also in the politically based decision to intervene at all, in particular in light of later negotiated hair-cut of the creditors (in Greek case). Instead, the EU decision-makers seem to decide to temporarily ignore the existence of "no bail-out" clause in the EU primary law and to survive a period of this "legal discomfort" until the specific "assistance clause" inserted in the Article 136 TFEU (mentioned above) becomes effective.

The activity of the EU decision-makers in years 2010–2012 combined instruments adopted within the EU/Eurozone framework (EFSM, "six-pack", Euro Plus Pact) and measures adopted externally (EFSF, Fiscal Compact). In principle, use of extra-EU instruments as a solution of the EU-wide problem, is not banned by the EU law, as it seem in cases of Schengen and Prüm Conventions. However, the EU law also contains several provisions that set limits to freedom of member states to act outside the EU framework, the most famous of them vested in Article 344 TFEU (pre-Lisbon Article 292 TEC) which prevents the EU states from using non-EU mechanisms to solve of their mutual disputes emerging from the EU law.

The Fiscal Compact in particular has potential to cross these limits by its intention to incorporate some EU institutions into enforcement of its own rules. Regardless of the fact that the Fiscal Compact has been formally concluded outside the EU treaty framework, it contains many references to the EU law and the EU institutions. The European Commission and the Court of Justice are, by virtue of the Fiscal Compact, asked to monitor, evaluate and, even by means of financial sanctions, en-

[85] For debate, see Gregorio Merino (2012, p. 1633).

force compliance with some of the Compact's provisions. In particular, both institutions are vested with powers to control and enforce member states' obligation to implement Compact's rules by domestic norms of "preferably constitutional nature" (Compact's Article 3, paragraph 2). If a member state fails to comply with this requirement (i.e. fails to adopt the respective legislation), the case can be brought to the Court of Justice and, in case of continuous non-compliance with the judgment declaring a violation, the EU Court is authorized, again by virtue of the Compact, to punish the non-complying state by financial penalty up to 0.1% of its GNP.

Formally, this new Court's power is based on an inter-state arbitration agreement rooted in a provision of the Lisbon Treaty authorizing member states to submit any mutual dispute *"which relates to the subject matter of the Treaties"* to the Court of Justice by means of a special agreement between the parties of the dispute (Article 273 TFEU/pre-Lisbon, Article 239 TEC). However, even if the dispute raised the by practice of the Fiscal Compact obviously falls within a category of "disputes related to the subject" of the European integration, the Compact's design raises several legal concerns. The Lisbon Treaty does not mention the European Commission in the whole procedure while the Compact relies on the Commission's very active role (preparation of reports, calculation of proposed financial penalty) and vest this institution with significant procedural prerogatives. Moreover, it is questionable whether the Article 273 TFEU provided for a blanket authorization to use personal and financial resources of the Court of Justice and the European Commission to control and enforce set of rules agreed by only a group of EU countries.[86]

The Fiscal Compact also has aspirations to modify the voting rules in the Council, further elaborating changes brought by the "six-pack." One segment of the "six-pack" reform strengthens the SGP's enforcement procedures with the objective to prevent repetition of the 2002/2003 affair when the spirit, rationale and even the Stability and Growth Pact's procedures were disrespected by the Council in the procedure filled by the European Commission against Germany and France. In other words, the reformed GSP intends to limit the political discretion in its application and to make its violation more costly, both in political and financial terms. Key element of this change is the introduction of a "reverse vot-

[86] See Klusák, Pítrová et al. (2012, p. 57). For different opinion of the Legal Service of the Council, see Lenfeld, Přenosil, Nedvídková (2012, pp. 84–85).

ing procedure" in the Council by the "six-pack". The essence of this new procedural rule is the requirement that sanctions under the SGP, as proposed by the Commission, are considered to be adopted unless the Council explicitly, by qualified majority vote, opposes them within a relatively short (10 days) deadline.

The Fiscal Compact goes even further when the Eurozone states committed themselves to *"support the proposals or recommendations submitted by the European Commission where it considers that a Member State of the European Union whose currency is the euro is in breach of the deficit criterion in the framework of an excessive deficit procedure".* This rule can be ignored only when a qualified majority of Eurozone states oppose the Commission's decision. Regardless the inspiration by the "six-pack", the provisions of the Fiscal Compact are more ambitious than the adopted EU legislation. They create a "voting cartel" of Eurozone states and "upgrade" it from level of secondary EU law ("six-pack") to amendment of voting procedures under the EU primary law, thus bypassing standard EU treaties amendment procedure (Klusák, Pítrová et al., 2012, p. 55–56).

A strong and ambitious conditionality has become an essential element of every EU/Eurozone intervention during the crisis (Šlosarčík, 2012, pp. 78–81). It covers primarily those domestic issues of the recipient state with significant impact on its financial situation, including public spending in the most "expensive" chapters of the national budget, such as education or welfare system. In these policies, however, the European Union frequently lacks strong "hard" regulatory powers, including competence to harmonize national legislation. Therefore, the expanding conditionality connected with the financial assistance in years 2010–2012 has created a tension with the principle of the conferred powers of the EU, which has central position in the system of the EU governance (Article 5 TEU).

The practice of the EU's, Eurozone's or quasi-EU's financial intervention in years 2010–2012 usually demonstrates a relative hostility to country-specific "complications" during its implementation phase. These "complications" could include even procedures rooted in the constitutional traditions and principles of the respective country, such as constitutional review of the governmental action, rules of the parliamentary approval of the legislation or possibility to organize a referendum on governmental policies. Political pressure exercised by the other Eurozone states on Greece with objective to prevent Greek plebiscite on acceptance of condi-

tions of its (second) bail-out (Editorial Comment, 2011, pp. 1775–1776) or Slovak experience during delays in ratification of the EFSF reform in Slovak parliament in 2011 have received sufficient political and media coverage. From the perspective of the EU law, the Greek and Slovak experience could be easily interpreted as colliding with the EU's obligation to respect the constitutional identities of member states, as explicitly stated by the Lisbon Treaty (Article 4, paragraph 2 TEU).

## 10.4 Conclusions: "Running Away from Lawyers" – Obscuring the Essence of the Problem

The Fiscal Compact was frequently welcomed as a much needed mechanism to tackle the fiscal responsibility of the EU states but with several problematic "frictions spots" with the EU law (Klusák, Pítrová et al., 2012, pp. 65–66). Some authors even interpret the "run from lawyers" during the 2010–2012 Eurozone crisis in a positive light as the evidence of the "return of a sovereign", represented by member states vested with a prerogative to violate the positive law in case of a crisis, to into the process of the European integration (Belling, 2012, p. 7).

However, the EU's "run from lawyers" during the Eurozone crisis also has the potential to significantly hamper the functioning of the European integration project in the future. Firstly, the European Union declares itself as the community based on rule of law (article 2 TEU); and the law-abiding character of the European integration was frequently used as the feature distinguishing the EU from other international organizations, strengthening the legitimacy and attractiveness of the former one. Lack of a robust legal basis for the EU action decreased the predictability of the EU's action[87] and contributes significantly to fears that domestic constitutional courts could "rebel" against the EU actions (repeating a "Solange" scenario from Germany of the 70s and 80s) and/or to risk that a legal challenge could emerge before the EU Court. Last but not least, the legal controversies connected with the Fiscal Compact and other EU

[87] Slovak experience of years 2010 and 2011 demonstrates lack of predictability in vaguely defined legal space. While in 2010, the legal character of the "Greek Package" was respected and Slovak effectively retained the power to use the ratification argument to abstain from the new mechanism, when the Slovak government tried to rely on legal argumentation in autumn 2011 when failing to ratify the amendment of the EFSF treaty, it experienced strong political pressure from other Eurozone states which led to the treaty ratification in Slovakia (by repetition of the voting in the parliament) but also caused collapse of the governmental coalition.

initiatives have provided for an "easy" argument (or escape route) for those state actors reluctant to participate, leading to legalization of the domestic debate and imploding the political and economic analysis. For instance, when the Czech Republic refused to join the Fiscal Compact, their argumentation concentrated on the legal weaknesses of the project, thus marginalising the need for broader analysis of the Compact's consequences for the Czech Republic.[88] Therefore, even if the "run from lawyers" could be justified in the first phase of the crisis when the EU lacked instruments for immediate action, it is much more difficult to argue in favour of a cavalier approach to the EU law in drafting long-term solutions, such as the Fiscal Compact.

[88] The most critical and influential analysis of the Fiscal Compact, commissioned by the Office of the Prime Minister, focused almost exclusively on the Compact's legal fallacies (The Office of the Government of the Czech Republic, 2012).

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# IV

# Epilogue

# Epilogue

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Ten chapters in this volume provide the thorough, thoughtful and sometime provocative analysis of the state of the Eurozone, and its effort to stabilize and reform itself. Limits to these efforts are explored, sometimes challenged and alternatives are proposed. Indeed, it is possible to argue that the analysis is incomplete. But it was not a goal of this publication to provide a definitive word on the subject. Rather, authors aimed at exploring the ideas, with a rather modest aim to initiate a discussion and perhaps to provide a thought or two to enlighten and inform the readers.

Indeed, for the Eurozone (and, of course, the whole EU) the important question is the about the future. Analysis of the past undoubtedly helps – indeed, it is the only one possible. However, the future must reflect more than past trends. The questions must be asked about the feasibility of the EU existence – and specifically the common currency – in the dynamic and competitive globalized economy of the 21$^{st}$ century. In the context of the Eurozone (and the EU as a whole) such questions include the inquiries in the North-South relationship, the degree of not only the economic, but, crucially, the political centralization in the Eurozone. And, indeed, the role and feasibility of structural changes across to space of both the national and the transnational (i.e. the European) realities.

The discussion in Section 2 of this volume indicated that that the measures EU adopted in the last 3 years and the radical changes in the ECB policy stance stabilize the Eurozone situation for now. However, even here there may be a very heavy price to be paid in the future. Blatant disregard of the principles enshrined in the EU treaties (especially the "no bail-out" principle) and the ECB abandonment of their strict mandate not to get embroiled in any policies besides the stabilization of prices (the OMT certainly qualifies here) implies that the future in fact became more rather than less uncertain. In the language of Kydland and Prescott, rules were sacrificed to discretion. Policy responses became another "probabilistically distributed" factor. There is a danger that without the known rules and hence the predictable responses, the economic future of the EU becomes a cauldron of chaos, gloriously (or

ingloriously?) presided over by pompous, but rather clueless EU summits.

Moreover, this reality casts shadow over any considerations of banking, fiscal and (eventually) the "political" unions. If a relatively simple rules (the "no bail-out" clause) were thrown overboard to accumulate the political imperative, what can one expect about the validity and durability of the rules which are absolutely necessary to make a banking union operational. And the importance of the argument only grows when one start to think about possible shapes of the fiscal and political unions.

The danger of the building of "ever closer union" – i.e. the increasing institutional integration with the EU and especially the Eurozone – in the environment where commonly proclaimed principles and the operational rules becomes flexible and often the little more than "optional" is twofold. The policy application of a "discretion" on the Eurozone (and even the EU) level may lead to an increasingly chaotic environment, forcing the individual participants to reassert their autonomy – and destroying the commonality of the economic space and the currency in the process. However, more dangerous would be an attempt to preserve the Eurozone and the commonalities of the economic space and currency by centralization on the top, limit in the member states to a status of administrative units. In the foreseeable future, any such attempt would have to undemocratic – i.e. dictatorial. The dream of the European unity would them become the nightmare. After all, individual freedom and liberty is the most precious asset humanity has.

The reform of the Eurozone (and perhaps the whole EU) is inevitable, if the common currency is to survive in the long run and the EU is to proceed to be an important player in the globalized world economy. But, indeed, a lot of thinking is needed. Political compromises are necessary, but so are the credible rules and regulations. The image of the ideal is not the ideal itself – and as the proverb says: Road to hell is paved by good intentions.

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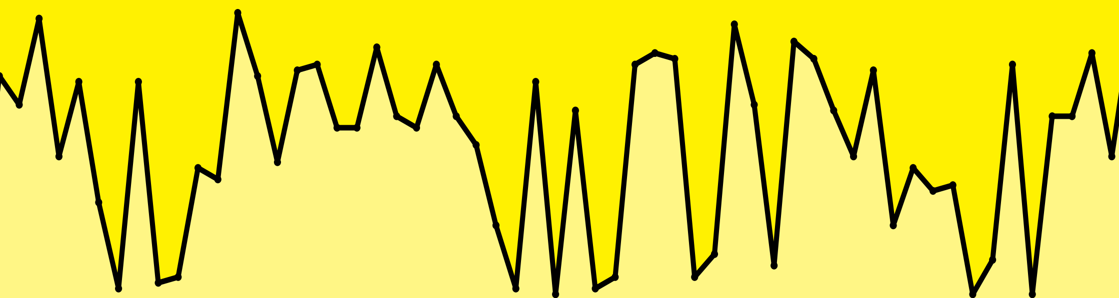
# Political Economy of Eurozone Crisis

# Reforms and Their Limits


**Eurozone (and implicitly the whole EU) finds itself at the crossroad. Economic "dynamism" of the last few years resulted in the growing differences between the Northern European "core" centered on Germany and the Mediterranean countries plus Portugal and Ireland. France stands economically in the middle. However, the growing number of observers and economic commentators stress that France is sliding from the "dual leadership" (together with Germany) to a biggest – and certainly most important – member of the "Mediterranean" group.**

**Indeed, for the Eurozone (and, of course, the whole EU) the important question is the about the future. Analysis of the past undoubtedly helps – indeed, it is the only one possible. However, the future must reflect more than past trends. The questions must be asked about the feasibility of the EU existence – and specifically the common currency – in the dynamic and competitive globalized economy of the 21st century. In the context of the Eurozone (and the EU as a whole) such questions include the inquiries in the North – South relationship, the degree of not only the economic, but, crucially, the political centralization in the Eurozone. And, indeed, the role and feasibility of structural changes across to space of both the national and the transnational (i.e. the European) realities.**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