Rethinking Economic Governance and

European Integration after the Crisis

Athens University of Economics and Business

Msc Program in International and European Economics

Margarita K. Iliopoulou

Abstract

The purpose of this dissertation is to analyse the process of European monetary integration taking into account the interaction of economics and politics during that process. Topics of high interest remain how the fragility of the system forces institutional changes, how political and economic actors coordinate, how the distinction between fiscal and monetary policies worked out, how the crisis challenges both the economic and the political theories of European Integration, which institutional and structural reforms do the heterogeneous monetary union need and whether the Euro is a buffer against or a contributing factor to crises.

Among others we examine the impact of the Euro crisis on the governance framework as well as the concepts underpinning it. We adopt a dualistic approach regarding the European Economic Governance before and after the crisis of 2010. We gather all relevant arguments concerning the completion or fragility of each framework and we evaluate the sufficiency of the latest reforms of the economic Governance post 2010. Furthermore, we elaborate on the new rationale of the EMU compared to the founding principles that motivated it originally. Taking into account the evolvement of the ECB we extensively examine its role and whether it worked in a positive or negative manner through a comparative perspective considering the differentiated interests and characteristics of a series of Eurozone countries.

Table of Contents

Chapter 1. Introduction: Crisis – A miracle in disguise

"One Market, One Money". That was the initial message of the European Commission, when in the early 1990s it conducted an evaluation regarding the potential benefits and costs of forming an economic and monetary union (European Commission No44, October 1990). The European Council agreed on the formation of an economic and monetary union at Maastricht in 1991. The Maastricht Treaty provided for the establishment of a common monetary policy, a common currency and an independent central bank. Nowadays, the initial Commission message "One Market, One Money" is not absolutely representative of the current European reality.

The introduction of the Euro is considered as one of the biggest turnarounds in the European Economic Integration efforts because it provides the member countries a platform to work in cooperation. The successful establishment and development of the Euro system is the most significant aspect of European economic integration as it is the most perceptible common factor of the European Union. However looking at the deep financial crisis Eurozone is experiencing, it is important to consider the weaknesses of such an extensive connection among different economies of the Eurozone.

The advent of the euro crisis in 2009 seems to have revealed the incompleteness and inherent fragility of the Eurozone institutional design, a fragility that arguably made the euro crisis an accident waiting to happen. This silver lining of the ongoing crisis is the fact that it reveals fundamental structural flaws in the entire European construction that were undermined in the past because of the prevailing "political culture of total optimism" (Majone 2011). Crisis revealed already existing persistent divergences among members of the Eurozone against the hope of the founders of EMU that monetary integration and fiscal and economic policy coordination would lead towards convergence of these economies.

EMU has always been primarily a political, not an economic project; thus, the fact that the project was not abandoned despite the critique of some of the world's top economic experts and despite the ongoing crisis is not surprising at all. After all, it is the "dark secret" of the European Monetary Union that the Article 111 (2) of the EU Treaty dealing with an exchange rate system in relation to non-EU currencies was intentionally ambiguous and in fact nobody was clearly in charge of exchange-rate policymaking (Wyplosz, 2000).

Over the last years, the Eurozone members have done a remarkable job managing the short-term symptoms of the crisis, although the costs have been great. Apart from the concrete results, there plays an important role the procedure as well. The EU is supposed to be a free association of sovereign states enjoying equal rights and duties and united by the a common purpose being served by their loyal cooperation. However, the concentration of decision-making powers in very few hands has reached an unprecedented level justifying the assertion of an elitist character of the European integration project (Majone, 2009).

Those voices asking for a sort of fiscal federalism were once neglected; nowadays they are widely expressed and tend to gather supporters even among their previous enemies (McNamara, 2006). Yet the long-term challenge remains: European Integration. Economic integration remains a matter of vital importance, since it can assure that a single monetary policy can be achieved at a reasonable cost and ensure sustainable benefits for each and every member-state.

European Union vision is now at an historic crossroads and could over the next months reach its limits. Although a lot of papers have been written regarding the short-term treatment of the crisis and the relevant policy decisions, not so much have been written regarding the actual direction of European Integration after the crisis. The purpose of this paper is to examine in which ways and to what extent the ongoing crisis has challenged the economic and political theories of European Integration.

At first we will examine the core economic theories of European Integration under the light of the current economic crisis. A major question that arises nowadays is to what extend had these economic theories properly conceived the sui generis nature of the Eurozone. During the crisis there has been so much emphasis on asymmetric shocks according to the original OCA theory. It is possible that a false perception of a monetary union may lead to improper political decisions regarding the crisis treatment approach. More specifically, we will examine the evidence concerning asymmetric shocks in the Eurozone and their compliance with the OCA theory. We will examine whether the economic theories of monetary integration have been a useful tool so as to prevent and properly handle the ongoing crisis or not. In case they have proven to be incomplete or irrelevant we will systematically gather the critique against them and the arguments aiming to their advancement.

Then, we are going to adopt a dualistic approach regarding the European Economic Governance before and after the crisis of 2010. We will gather all relevant arguments concerning the completion or fragility of each framework and we will evaluate the sufficiency of the latest reforms of the economic Governance post 2010. We will examine the role of the European Central Bank during the crisis through a comparative perspective that will take into accounts the differentiated interests and characteristics of a series of Eurozone countries.

Furthermore, we will elaborate on how these reforms may function as a pathway so as to deepen economic integration. The main question at that point will be whether these reforms have entailed a much greater integration of the core powers of (predominantly Eurozone) member states or not. If the answer is negative, European economic integration may have been reduced to a zero-sum equation of winners and losers that becomes a matter of necessity rather than an effort of common purpose.

There comes the question regarding the nature of the fiscal policy within EMU, meaning whether it is about legally binding rules or a matter of discretion. It is a matter of great importance since the adoption of purely political incentives may change the final outcome of the crisis. Even if there is no decision aiming directly to further integration (i.e. budgetary union), it is still crucial to examine the intermediate steps of European integration and more particularly their enforceability and impact.

That distinction between politics and economics has been the core challenge the crisis and their proper combination remains the main challenge of the near future. It is a scientific debate in direct dialectic relationship with the current EMU arrangements. EMU remains a mainly political project seeking for sustainable adjustments. It is vital that we examine in which way and to what extent the current crisis has challenged the predominant economic theories of European Integration, since it may be the safest way to trace what is most applicable to the sui generis Eurozone.

Chapter 2 Challenging the economic theories of European integration

2.1 Introduction

After a half-decade of economic turmoil throughout the Eurozone, serious doubts have been raised regarding the ultimate viability of Europe's common currency. To some, the euro has been—and always will be—a hopeless effort, guided by unrealistic political ambition as opposed to rational economic logic. Indeed, this claim is bolstered by the half-century old theory of optimum currency areas (OCA). However, we weigh the evidence supporting the original OCA theory's applicability to the Eurozone, ultimately arguing that the initial theory does not describe the Eurozone crisis. Instead, new refinements that expand from the original asymmetric demand shock model provide more accurate evidence for the Eurozone. In order to demonstrate this point, we will first review OCA theory as presented in Mundell's asymmetric shock model. Then, we will turn to more modern analysis of OCA theory, demonstrating its application to Eurozone; by focusing on more recent empirical work, we will show how modern interpretations have advanced beyond the original theory. Finally, we conclude by assessing why this empirical work has departed from the original theory.

2.2 The original Optimum Currency Area Theory

The origins of optimum currency area theory date back to the early 1960s, well before any explicit proposal for European monetary integration. Robert Mundell initiated the academic debate over currency areas in his seminal 1961 paper by asking, "[w]hat is the appropriate domain of a currency area?" (Mundell 1961: 657). Without respect to the type of fixed exchange rate regime, Mundell introduces a model whereby policy-makers may weigh the costs and benefits of participating in such a regime. In order to illustrate the costs facing a country constrained within a currency area, this model supposes two countries are joined in a currency union. Subsequently, this economy is subject to a shock in aggregate demand that shifts demand from one country to the other; in other words, the two countries experience an asymmetric demand shock. By analysing the manner of adjustment to this asymmetric shock, Mundell proposes a number of criteria that may help to smooth over the shock to aggregate demand. The most important criteria in Mundell's model for an optimum currency region thus becomes, "internal factor mobility and external factor immobility," (Mundell, 1961). Beyond factor mobility, this initial model was expanded through subsequent consideration by the likes of Ronald McKinnon and Peter Kenen. McKinnon's initial contribution to the question contains many notable insights. First, he discusses how the structure of an area's economy, especially the ratio of tradable to non-tradable goods, can either offset or exacerbate the costs of monetary union; second, he distinguishes the notion of factor mobility between mobility within the region and mobility between industries (McKinnon 1963). Finally, Kenen introduces the prospect of coordinating fiscal policy at the same level of monetary policy—and how such a set up might contribute to smoothing asymmetric shocks (Kenen, 1969).

Yet, all of these considerations offset the one overarching cost of monetary union in the original model: asymmetric shocks sans exchange rate adjustment. To understand the concept of asymmetric shocks, let us suppose that consumer demand shifts from French-made products to German-made products, an asymmetric shock in aggregate demand. This causes the aggregate demand curve to shift upwards in Germany while it shifts downward in France. As a consequence, France would experience increased unemployment, whereas Germany must confront inflationary pressure (De Grauwe 2010).

When two or more countries are not part of a monetary union, they may use their national monetary policy to adjust to asymmetric shocks, irrespective of their exchange rate regime. First if their exchange rates are flexible, France could lower its interest rate and thus boost aggregate demand in order to adjust to the asymmetric shock proposed above. Secondly if they have fixed their exchange rates to another currency, devaluing provides a means of adjustment. To apply this to our example of above, France would have been able to devalue the franc against the mark and increased competitiveness and spur demand. Yet, when two or more countries abandon their national currency and adopt a common currency to form a monetary union they lose their monetary independence.

Thus, the original OCA theory proposes alternative means of adjustment, such as wage flexibility, factor mobility, or fiscal transfers. From our previous example of Germany and France, let us assume that wages in France and Germany are flexible. The unemployed French workers will reduce their wage claims; consequently, the supply curve in France will shift downwards, with the opposite effect occurring in Germany. These shifts produce a new equilibrium wherein the price of output declines in France and the price of output rises in Germany, causing the French products to be more competitive. Conversely, the German products become less competitive and thus the demand for them is reduced. Another phenomenon that adjusts for the asymmetric shocks is the mobility of labour. When aggregate demand goes down in France and goes up in Germany, the unemployed labour moves to

Germany. This move of workforce prevents the wage levels from declining in France and the wage inflation in Germany. Thus in the absence of factor mobility as described above, the disequilibrium would have led to unemployment in France and inflation in Germany. Moreover, a system of automatic fiscal transfers can smooth demand disruptions in times of temporary shocks by allowing stimulus funds to flow from Germany to France in the example described above, supporting aggregate demand in France while reducing inflationary pressure in Germany (De Grauwe 2012).

2.3 The compliance of the Eurozone Crisis with the OCA Theory

The OCA theory seems to produce recommendations commonly suggested in light of the ongoing Eurozone crisis. Indeed, the prospects of European integration were never far from the debate on OCA theory. After all, Mundell suggests that the direction of the European project will likely lead deeper monetary ties: “In Western Europe the creation of the Common Market is regarded by many as an important step toward eventual political union, and the subject of a common currency for the six countries has been much discussed,” (Mundell, 1961).

Nonetheless, this original OCA theory asks a decidedly different question than that question with which European policymakers have continued to wrestle. OCA theory provides a seemingly simple tool—cost-benefit analysis—with which to evaluate the question of monetary integration; however, the perspective is that of a national policymaker contemplating joining a currency area. Indeed, there is no account in the original model for a sprawling, open-ended monetary union that plays a role in a much deeper political movement. Crucially, this difference can be seen in the context during which the theory was developed. Mundell's original theory was proposed in response to the ongoing debate between advocates of flexible exchange rates, on the one hand, and fixed exchange rates, on the other.

Indeed, the theory's primacy of exchange rates as an adjustment mechanism has been retrospectively criticised as operating within a classically Keynesian mind set of meticulous economic intervention, which Buiter has labelled the “fine tuning fallacy.” (Buiter, 1999). Therefore, the dated assumptions of the original OCA theory challenge its applicability to the modern Eurozone (McKinnon 2004; de Grauwe 2006). Nonetheless, OCA theory has been applied as an analytical tool to determine whether the European Union constitutes an optimum currency area; we address the empirical evidence for the theory below.

As a result of this original OCA theory, there have been significant concerns regarding asymmetric shocks that only hit a single or a few countries. If idiosyncratic shocks occur, this must mean that the economies within the union exhibit divergent patterns of Gross Domestic Product (GDP) growth. If significant asymmetries of GDP growth occur, monetary union may lead to a loss of welfare due to the lack of independent monetary policy, unless mechanisms for achieving international income insurance and consumption smoothing (risk sharing) have been established. Increased intra-industry trade and further economic integration could reduce country differences which cause asymmetric shocks and can theoretically cushion against their adverse effects. On the other hand, an increased regional concentration of industries could lead to asymmetric shocks. Empirical evidence suggests that business cycles in EU countries have become more synchronized since the 1980s. However, not all economists fully agree with this claim.

If verified, Krugman's paradox of increased integration leading to greater asymmetries between regions suggests that asymmetric shocks will be a recurring and permanent feature of any currency union, including the Eurozone. Thus, they increase the costs of EMU membership for individual countries, as their negative effects are amplified by the free flow of capital, factors and labour that come with closer integration. This is especially serious in the case of the Eurozone, as the crucial instrument capable of blunting the effects of such asymmetric shocks and of smoothing regional growth differentials –a federal fiscal authority– is notoriously absent.

Since Krugman believes that these regional or state-level shocks are permanent, this leaves little room for fiscal spending at the regional level and further increases the importance of establishing a supranational fiscal authority for the entire Euro area. This lack of a transfer mechanism that would help to correct for diverging long-run rates of growth and business cycle asymmetries means that having a 'one-size-fits all' monetary policy (in the form of a single interest rate set for the entire union as a whole) will serve to further amplify differences between members of the Eurozone, thus leaving the currency union in a precarious position both economically and politically.

The analysis by Frankel and Rose (1998) seems to paint a much more optimistic picture of the role of trade integration and asymmetric shocks for the Euro area. In a study that uses thirty years of data for twenty industrialized countries, they find that closer international trade links result in more closely correlated business cycles across countries. Although countries are expected to become more specialized in producing the goods in which they have a comparative advantage, the authors believe that this will not necessarily lead to a greater salience of asymmetric shocks and inter-regional divergences in business cycles within a currency area. They expect that common shocks (such as demand shocks) will predominate, and that intra-industry trade will account for the majority of trade, thus lessening the potential disruptive impact of greater specialization.

In an application of the 'Lucas critique', Frankel and Rose reject that the use of historical data will accurately reflect the costs and benefits that Eurozone members face in participating in a currency union. They expect that monetary union will itself lead to a further boost to trade integration and hence business cycle symmetry. Thus, the importance of asymmetric shocks for the Eurozone is decreased as they expect that continued trade integration will decrease the costs of monetary union. As a result, the economic and political costs that Krugman expects such asymmetries to produce will not be realized, with the immediate implication that the Eurozone is a much more stable and viable entity in the absence of a supranational fiscal authority.

Frankel and Rose's findings are further complemented by a study conducted by Kalemi-Ozcan, Sorensen and Yosha (2004), who argue that for both US states and European countries the level of GDP asymmetry has declined dramatically from the 1980s to the 1990s and that country-level and regional-level business cycles have become less asymmetric (2004). Kalemi-Ozcan et al. also construct a measure of 'risk sharing' between Eurozone countries that they believe acts as a 'corrective' mechanism in the manner of Krugman's federal fiscal authority: cross-border ownership of financial assets is expected to provide a buffer against asymmetric shocks and help to further increase long-run growth and business cycle symmetries.

Their results confirm that an increase in risk sharing took place in the 1990s among European countries. In the period 1972-82, 'risk sharing was basically nil', while for the period since 1993 until the date of the study risk sharing was 'positive and clearly statistically significant' (Kalemi-Ozcan et al. 2004). The evidence shows that country-level specialization in the EU has been increasing during the 1990s; however, GDP asymmetry has declined in the 1990s relative to the 1980s. Moreover, relevant evidence indicates that the income of EU members is slowly becoming buffered against asymmetric shocks to GDP. In any case, asymmetry of output (GDP) may not be that important for the members of the EU if there is substantial risk sharing between members of the union.

Kalemi-Ozcan et al. claim that their evidence supports the idea that countries in the EU are still evolving into a level of risk-sharing similar to that of the United States. One their highly promoted recommendations for boosting inter-country risk sharing is for EU governments to remove barriers from the international flows of credit and to allow for the merger of cross-border financial institutions.

However, at this juncture it is possible to criticize some of the conclusions and policy recommendations made by Kalemi-Ozcan et al. A significant point of criticism is that, to date, there has been little empirical evidence to support the claim that more specialization and thereby more output asymmetry will not necessarily trigger more asymmetry of income (and consumption). Moreover, by claiming that a further diversification of member states' portfolio of investments will result in greater 'risk sharing' and by advocating that states within the Eurozone be more supportive of cross-border mergers of financial institutions, they seem to underestimate the risks that financial instability and such cross-border linkages pose. The prevalence of such (imperfect) linkages may actually increase the prevalence and severity of asymmetric shocks in a currency union.

Most of the empirical evidence (Sorensen and Yosha 1998; Afonso and Furceri 2008) suggest that the effectiveness of risk sharing mechanisms at the international level is lower than at the inter-regional level. That becomes even more profound within the Eurozone because of the absence of a supranational fiscal risk sharing mechanism. In fact, the effectiveness of risk sharing mechanisms in the euro area is significantly lower than in existing federations, such as the U.S. (IMF WP 13/198). The chief difficulty in being fully able to evaluate the effectiveness of risk sharing mechanisms to smooth business cycle fluctuations is due to the fact that there is little extensive empirical evidence regarding those mechanisms during periods when they are most necessary, i.e. during recessions.

As we saw in the crisis of the Eurozone, large capital outflows from the periphery of the currency union resulted in a highly asymmetric shock that further exacerbated the crisis of the periphery relative to the centre of the euro area. Kalemi-Ozcan et al. and even the original Mundellian paradigm for an optimum currency area did not foresee the potential instability of a union resulting from weaker members losing massive amounts of capital through legal and illegal capital flight even as stronger members attract large capital inflows, often from the distressed regions themselves. The supposed risk sharing that the authors had found to be present within the Eurozone failed to stabilize and correct for the differences within the euro area and in fact exacerbated the severity of the asymmetric shock that eventually hit Greece, Spain and others.

The outcome of the current crisis indicates that risk sharing mechanisms are typically ineffective when they are most needed. The amount and intensity of shocks that cannot be easily smoothed in periods of recession is significantly larger in comparison to those that come up during normal times. This increased inability to smooth output shocks is driven by the lack of consumption smoothing provided mainly by private saving. In order to face a large and unexpected shock, citizens and the government of a country would need larger amounts of credit which they may not be able to obtain (IMF Working Paper 13/198).

Moreover, the increasing prevalence of unsmoothed shocks compared to more symmetric downturns can result in increasing the cross-sectional average of unsmoothed shocks. This is a particularly crucial implication concerning the Eurozone, since, as a result of the absence of alternative risk sharing mechanisms and the weaknesses of those mechanisms that are already in place, the current weak fiscal positions (high debts and deficits) of many states could limit even further the ability of automatic stabilizers to provide insurance against asymmetric shocks.

2.4 Conclusions

Throughout this chapter we have outlined several changes that have undergone within the framework of the debate on OCA theory since its inception by Mundell in 1961. Modern contributions to the literature have continued to analyse the degree to which asymmetric shocks factor into the cost-benefit calculation of being part of a currency union, and extensive empirical research has been undertaken to examine how this calculation applies to members of the Eurozone. However, in so doing, the modern interpretations of OCA theory have deviated from the original analysis in several ways. Firstly, as we saw in Krugman's analysis, the debate has shifted to an analysis of the role of the potential adverse effects that trade integration can have in the absence of a fiscal union. While Krugman argued that it increases both the prevalence and costs of asymmetric shocks, Frankel and Rose disputed this interpretation and emphasised the 'smoothing' role that intra-industry trade can play in neutralising asymmetric shocks. More recently, the OCA debate has shifted to an analysis of the role that 'risk sharing' in its many forms -but crucially excluding fiscal union- can help to lessen the impact of asymmetric shocks.

Nevertheless, all these modern interpretations of OCA theory interpretations have proven to be quite vulnerable to critique arising in the wake of the recent Eurozone crisis. The overall evidence of the role of asymmetric shocks in the Eurozone is not clear-cut: while Krugman's pessimistic account of the OCA criteria has been rebuffed by the likes of Frankel and Rose and Kalemi-Ozcan et al., the latter findings have themselves been proven vulnerable to critique in the wake of the Eurozone crisis. The free flow of capital, mobility of factors and cross-border ownership of assets can be said to have helped to exacerbate the asymmetric shock that hit the periphery of the Euro area, thus lending some credence to Krugman's earlier dire predictions and questioning the adequacy of de-centralised and 'financialised' forms of risk sharing. Although one can argue that this was the result of not applying the requirements of labour mobility and fiscal union that were emphasised in the original OCA theory, it is clear that this is more a reflection of the limitations of the original theory itself in using it to analyse a heterogeneous and sprawling union like the Eurozone. The original OCA theory provided only an economic 'cost-benefit' analysis that, due to ignoring the political economy and cultural problems associated with a heterogeneous currency union, is in itself too narrow an analytical tool for understanding and reforming the Eurozone.

Chapter 3 Economic governance prior to the sovereign debt crisis

3.1 Introduction

This chapter will consider the status of European economic governance prior to the European sovereign debt crisis in 2010. In order to evaluate properly the reforms of the European Economic Governance following the current crisis, it is essential in the first instance to offer a concise overview of economic governance prior to the onset of the crisis so as to establish a conceptual framework regarding the policy framework of the EMU. We will examine whether the initial rules of the EMU have been properly enforced to all member states or not. The enforcement of that kind of rules defines the completion of a monetary union and the degree of fragility in case of a crisis. Then, we will evaluate to what extent the policy framework of EMU made the crisis of different member states worse or has it just failed to prevent what it was supposed to prevent by comparing five countries (Spain, Italy, Greece, Germany and Latvia).

3.2 Economic Governance Prior to the Sovereign Debt Crisis: Rules without Enforcement

With the establishment of Economic and Monetary Union (EMU) via the Maastricht Treaty in 1992, interdependence between member states became the core feature of the economic union (Lelieveldt and Princen, 2011). As a result, there was a greater need for economic governance and coordination of macroeconomic policies. As Baldwin and Wyplosz (2012) attest, the policy provisions of the Maastricht Treaty established a broad-based regulatory framework in which economic governance could take place. A two-pronged fiscal governance system subsequently emerged incorporating: (1) a preventative facet of governance focusing upon macroeconomic surveillance; and (2) a corrective facet of governance that sought to redress the policy mistakes of member states.

For example, member states agreed to limit their budget deficits to 3 per cent of the total value of GDP and to curtail their debt to no more than 60 per cent of GDP (Baldwin and Wyplosz, 2012). In addition, member states were required to adhere to a medium-term objective (MTO) so that states could adopt necessary measures (such as borrowing money for investment) in times of financial austerity without exceeding the 3 per cent limit (Baldwin and Wyplosz, 2012). Thus, countries were urged to attain a 'close to balance' (i.e. a 0.5 per cent deficit or less) or 'in surplus' position with regards to their national budgets (De Grauwe, 2012). However, as De Grauwe (2012) details, this represented an inflexible and discernibly rigid form of economic governance. As a consequence, the Stability and Growth Pact (SGP) (2005) refined the fiscal framework of European economic governance (De Grauwe, 2012). In the aftermath of the SGP, countries in the Eurozone could establish their own MTOs based upon domestic models of economic sustainability (Annett, 2006).

In addition to establishing a preventative mechanism, European economic governance prior to the advent of the sovereign debt crisis incorporated dissuasive measures. Most notably, the Excessive Deficit Procedure (EDP) was established as a means of enforcing compliance upon member states (De Grauwe, 2012). The EDP stipulates that if a country in the Eurozone breaches the rules on excessive deficit, the European Commission is empowered to impose stringent powers of macroeconomic surveillance upon the country and, if necessary, to impose sanctions and fines (Lelieveldt and Princen, 2011). However, while, in theory, the EDP acted as a deterrent against fiscal profligacy, in practice it is immensely difficult to attain consensus through the executive arm of the EU (Annett, 2006). As a result, countries that had breached fiscal rules tended to escape with little more than an official reprimand. Furthermore, after the advent of the SGP, states were able to extend deadlines for taking corrective action against excessive budgets, thereby further loosening the constraints of fiscal governance (Annett, 2006).

Viewed from this perspective, two points are apparent. Firstly, economic governance in the Eurozone is not a novel concept that has emerged post-2010. Rather, since the advent of the EMU, member states have adhered to the ideal of economic integration with specific and stringent rules put in place to act as a framework for facilitating good economic governance (Van Overtveldt, 2011). Secondly, it is also crucial to acknowledge the inherent limitations of economic integration via fiscal governance. Most notably, it is apparent that a non-binding nature of macroeconomic coordination policies and the limits placed upon enforcement ensured that economic decision-making remained rooted at the national level with member states dictating the pattern of domestic fiscal policies (Annett, 2006). Consequently, fiscal rules were regularly bypassed. For instance, in the period 1999-2007, the average budget deficit of the original twelve Eurozone countries was 1.8 per cent of GDP: far removed from 'close to balance' or surplus (Verhelst, 2011). Therefore, it is readily apparent that fiscal rules can only reap benefits if those rules are supported by a strong and unwavering political commitment from states (Verhelst, 2011). This is an important point to note and one that will be expanded upon in due course.

3.3 The fragility of incomplete monetary unions

The purpose of the EMU was to achieve exchange rate stability within the Euro area. After the collapse of the Bretton Woods and the ESM, countries were increasingly looking for a way to counter speculative attacks against their currencies by the markets. The initial European Monetary Union policy framework was based on a narrow central banking objective as well as several criteria that the Eurozone countries had to comply with. A founding pillar of the policy framework of EMU, the Stability and Growth Pact (SGP) requirement, aimed at achieving and maintaining price stability and fiscal responsibility within member states. According to it EMU countries' budget deficit and debt to GDP ratios should not exceed 3% and 60% respectively.

In order to ensure member states' fiscal discipline, article 125 of the Treaty of the European Union imposed a "no-bail out clause" which intended to combat the moral hazard problem that could emerge in the absence of the clause. Compliance with the SGP was supposed to assure fiscal responsibility within Eurozone countries, which had only delegated their monetary policy prerogatives to the ECB, while keeping the fiscal powers within national governments' hands. The EMU founders assumed that by centralising monetary policy and including a 'no-bail out clause', they would be able to avoid excessive budget deficits and maintain economic stability within the Eurozone (De la Dehesa, 2012).

Next, the European Central Bank's institutional design closely resembled that of the Bundesbank and was strongly influenced by the monetarist view about macroeconomic policy priorities. ECB was charged with the primary responsibility of maintaining price stability, defined as keeping inflation close to 2 percent (ECB, 2008). That was automatically believed to lead to financial stability, based on the assumption that markets are efficient. Furthermore, the ECB is designed to be a politically independent institution, a feature which is supposed to minimise any possibilities for external influence conflicting with the bank's anti-monetary financing policies. Ultimately, all that led to the adoption of a homogenous monetary policy which was to be implemented within a heterogeneous set of countries.

Since the inception of the Single currency project, a body of literature addressed some issues concerning the creation of a single currency union among European countries. De la Dehesa (2012) summarises the three main dangers for EMU, present in the economic literature, stemming mainly from its faulty design. The first EMU design failure derives from the fact that the Eurozone was not an optimal currency area (OCA) and as a result of that the 'one-size-fit-all' monetary policy could lead to divergent movements among the individual member states, ranging from being 'too loose' in some and 'too tight' in others.

According to a study by Lopez et.al (2011) while Eurozone inflation has on average been close to the 2% target, a much higher levels of inflation could be observed in Southern European countries after the introduction of the Euro. That means that such differentials are likely to have resulted in significant threats to the competitiveness of those countries, which considering the absence of appropriate adjustment mechanisms are expected to lead to adverse consequences.

And that naturally bring us to the second major problem stemming from the faulty design of EMU. It originates from the no-common fiscal policy feature of the EMU as well as no common European fund to address asymmetric shock. The overall governance of the EMU was grounded on rule-based prevention only, which presupposed no need for crisis management tools. However, De Grauwe (2012) notes that countries may have incentives to free-ride on an implicit assumption of a bailout and accumulate excessive debt levels within a currency union. As a result of that, a major question has arisen, namely whether the EMU policies framework is optimal for all countries or it disproportionately favours certain countries more than others.

3.4 The impact of EMU on different member-states (Spain, Italy, Greece, Germany, Latvia)

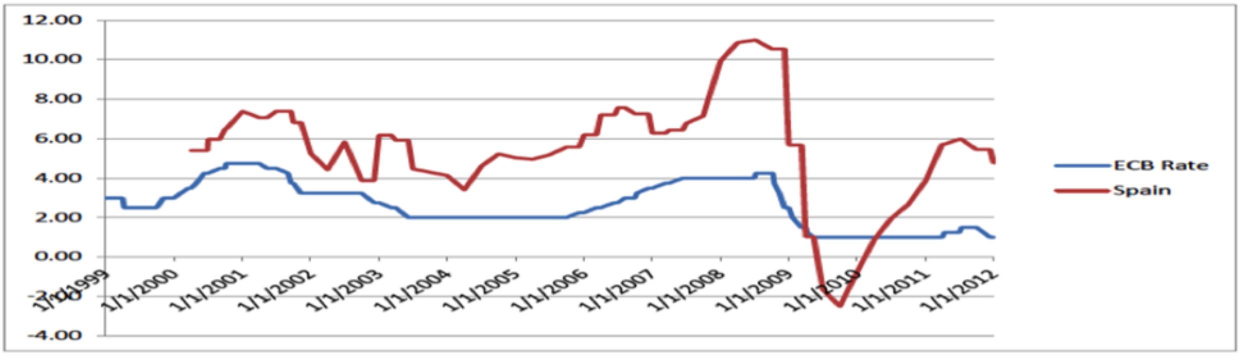
In order to establish the validity of the above-presented concerns, we will analyse the effects and consequences of the policy framework characterising the EMU for five individual countries - Spain, Italy, Greece, Germany and Latvia.

The case of Spain

In order to examine the effects of ECB's monetary policy framework with respect to Spain, we would first look at the impact of ECB's uniform interest rates policy before the crisis, and would then move on to the consequences of the lack of common fiscal budget as well as lender of last resort facility after the outburst of the crisis. Initially, the harmonised interest rate was very low (2%), mainly due to the fact that countries like France, Germany and Italy had low inflation and contributed to the calculated low Eurozone average (De la Dehesa, 2012). Nevertheless, inflation was consistently higher than 2% in many of the southern European countries, including Spain, and that is a fact that shouldn't have been overlooked. The application of a single interest rate to all Eurozone states, without considering any existing variations in their inflation rates, is expected to cause imbalances in the real interest rates since the countries with higher inflation would have access to practically negative real interest rates.

More precisely, the problem with negative real interest rates in 'catch up' countries like Spain is that they make credit much cheaper than it would otherwise be and therefore increase the likelihood of credit and housing bubbles formations. In order to see whether that was the case in Spain we use data by Srivangipuram (2012), who compares the actual ECB rate to Taylor recommended one. With regard to Spain, he finds that the ECB rate is persistently below the Taylor recommended level (Fig.1).

Figure 1 Comparison of ECB rate and Taylor recommended rate for Spain



Source: Srivangipuram (2012)

In other words, that suggests that the monetary policy adopted by the ECB, and hence implemented in Spain, was simply too expansionary for the economic conditions in the country. It concentrated on the levels of public debt, which were on a decreasing trend for years before the crisis, but it failed to prevent private debt accumulation. Judging from the data presented in Figure 2, our expectations for bubble formations are confirmed - banks' lending to private sector in Spain rocketed after the introduction of the Euro and that had two distinctive adverse effects on the Spanish economy – 1) development of large current-account deficit and 2) loss of competitiveness due to the artificially high increase in demand, which was not supplemented by a respective increase in productivity.

Figure 2 Loans to private sector – Spain

Source: www.tradingeconomics.com

Furthermore, the Spanish crisis revealed the hazardous link between banks and sovereigns, in the absence of a pan-European banking supervision, as well as the lack of fiscal union and Lender of Last Resort (LoLR). Once the bubble in the Spanish economy went bust in 2008, one could observe huge implications for the banking sector. Banks incurred enormous losses and faced the problem of illiquidity. Knowing the possible adverse effects of bank failures for the overall economy, the Spanish government had no other choice but to step in and bailout troubled banks using taxpayers' money. As a consequence, the government accumulated excessive amounts of debt, which later became a threat to its own solvency. That led to speculative attacks by the markets which raised the yields of Spanish government bonds to an unsustainable level, reflecting their expectations for possible default.

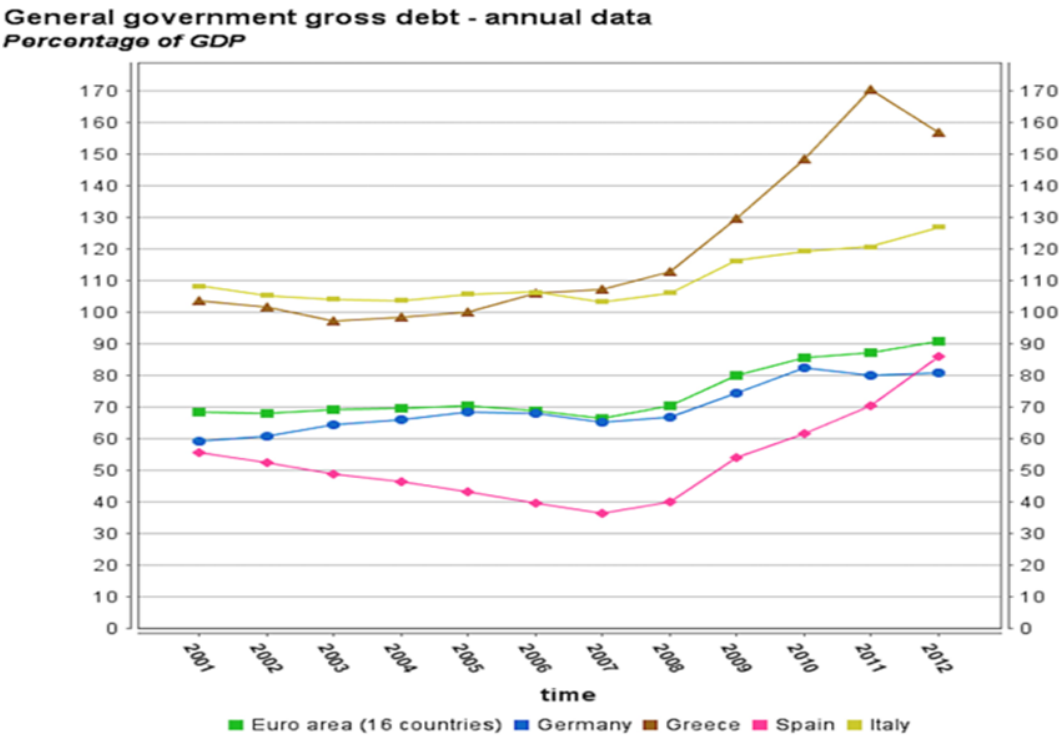
Because of all that, after the bust in 2008, the Spanish economy experienced a persistent growth contraction, as well as accelerating levels of government debt (Figure 3). According to the Economist (2011), this was mainly ECB's fault, and more precisely, it's reluctance to provide liquidity when it was mostly needed. De Grauwe (2011) explains why. He compares Spain and UK's debt to GDP ratios and illustrates the vulnerability of the Spanish economy because of its membership in an incomplete monetary union. The essence of the problem derives from the difference in the evaluation of the sovereign default risks of the two countries by investors and the markets. In a nutshell, if investors fear Spanish default, they could pull out their investments (in euro) and reinvest them in a more credible economy using the same currency (e.g. Germany), resulting in liquidity dry up in Spain.

Considering the inability of the Spanish government to force the ECB to provide liquidity, markets can in fact raise the interest rates on long term government bonds to such an extent that could force the country into default, something that cannot happen to the UK, for example. In other words, one may criticise the ECB for waiting for too long before launching its OMT operation which aimed to calm markets down. If launched earlier, Spain could have avoided accumulating such high debt (further analysis regarding ECB at the forthcoming chapter).

Based on this short analysis of the effects of EMU membership for the Spanish economy, we conclude that the 'one-size-fits-all' monetary policy as well as the lack of common fiscal fund and LoLR facility within the ECB seems to have made the crisis for Spain worse than it would have been if the country had not been a member of the union.

The case of Italy

Italy is a major actor in Europe and in the Eurozone since the country is the ninth biggest economy in the world and the third largest economy in the Eurozone. At the same time, Italy is one of the Eurozone countries with the highest level of debts. This level reached 130% of their GDP and the gross debt totals more than €2trillion (2013). The high level of debt is due to historical considerations as Italy went through a period of social trouble in the 1970s with high unemployment and inflation rate, aggravated by the oil crisis. As we can see from the graph below, debt to GDP ratio has always been higher in Italy than the average of the 16 countries composing the Eurozone.



Source: Eurostat

EMU accession was followed by a consumption boom related to the lower interest rates of the 2000s, as opposed to the high interest rates during the 1990s, under which the debt servicing burden for high public debt countries had risen.

Entering the Eurozone, Italy, like the other member states, lost its capacity to apply counter-cyclical budgetary policies (De Grauwe, 2011). In period of crisis Italy and the other countries of the Eurozone had to finance their automatic stabilizers by issuing debts in a "foreign currency" where they have no direct control over. Therefore, the market formulates a bonds premium related to the expected risk of insolvency of the country since the member states are not able to ensure that they will have enough resources to finance government expenditures and payback their bondholders.

The situation of Italy changed dramatically when the country came under pressure from the investors. They were considering the country as the weak link of the Eurozone due to their high level of debts: in November 2011, 10 years Italian bonds yield was above 7, 5% compared to 4.1% a year before. The absence of a lender of last resort raised investors' worries that the bonds may not be paid back which, in turn, led to a massive selling of Italian bonds, decreasing their prices and increasing their interest rates.

Apart from the common EMU policy framework another important factor that we have to take into account in order to properly examine the response to the crisis is the different varieties of capitalism identified among member-states. Throughout South Europe (especially in Italy and Greece) there may be identified a sui generis kind of capitalism as a version of state-led capitalism (Schmidt, 2002) that affected to some extent the response to the crisis. The characteristics of the banking system of each member state defined the nature of the crisis as well.

At the beginning of the crisis (2008) no Italian (or Greek bank or foreign bank operating in these countries) failed nor got rescued through direct public intervention despite the financial contagion via global channels of interdependencies. The two main Italian banks were mainly exposed to Central and Eastern Europe. The configuration of the Italian financial system and the regulatory framework and prudential supervision carried out by the Bank of Italy were the main reason for that.

The response of the supervisory authorities to the crisis was characterised as "prudent" and "systematic" (IMF, 2009). The policy of the Bank of Italy combined with the measures adopted by the Italian Government following close cooperation with the Bank reduced systemic risk and liquidity strains (IMF, 2008). The legislation as a response (f.e. recapitalisation of Italian banks through public funds, measures in advance of severe liquidity shortage, state guarantee for depositors, “Tremonti bonds”) to the crisis (October –November 2008) mirrored the responses articulated elsewhere in Europe and were in accordance with the Eurogroup at EU level (Pagoulatos and Quaglia, 2013).

While crisis was getting deeper, much of the effort was targeted at the survival of the Small and Medium Enterprises that constitute a core asset of the Italian economy. According to the OECD (2009) the state anti-crisis measures were fiscally neutral overall in macroeconomic terms.

Italy has been able to handle this situation to some extend thanks to the interventions of the ECB. The first one, the bond purchases via LTRO in December 2011, was not so effective since Italy borrowing costs remained unsustainably high. However, when the ECB’s president, Mario Draghi decided to circumvent the European treaty in affirming that “within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough”, the situation changed (July, 2012). This decision allowed to remove an eventual spectre of default and lowered the pressures on sovereign default as it can be seen in the following graph. It is only when the ECB decided, in a rather delayed manner, to play the role of lender of last resort that the crisis could fade out. Unfortunately, the damage was already done, if we think of limiting the vulnerability of countries to speculative attacks as a legitimate objective of the EMU policy framework.

Figure 4 - Italy Risk Premium evolution compared to Germany

Source: www.countryeconomy.com

A large amount of the public debt (almost 1/6 of it) had to be refinanced every year (OECD 2009) and the gross public debt exceeded 100% of GDP since 2008, while GDP growth rate reached -2,37% (2012) and remains extremely low.

Italy's membership in the Eurozone helped stabilize the situation during the financial turmoil since it made the possibility of currency crisis, meaning the lack of access to "hard currency", disappear. Otherwise, the Italian government would have been extremely vulnerable to its short term foreign debts, since it had been widely known as a weak currency country (such as Greece) prior to its euro accession. There remained some risk of a solvency crisis -not one of the Italian banks thanks to the reforms of the banking sector over the last years- but one of the Italian state, given the high levels of Italian public debt and deficit.

The case of Germany

In May 1998, 11 EU countries, including Germany, decided that the convergence criteria were satisfied and that the monetary union can become a reality (De Grauwe, 2012). Even though Germany was the driving force behind European integration - a leader or even a role-model for other countries in terms of fiscal policies - it failed to adhere to the criteria which were the result of the agreement following the multilateral negotiations. Bearing in mind that the final provisions of Maastricht were supported unanimously by the members of the Delors Commission, one should remember that the strict fiscal rules were largely inspired by German officials, who wanted to ensure that the future currency will be a 'hard' euro (Willett, 1999).

The aim of European integration especially in terms of a monetary union has been a heavily politicised issue (Baun, 1995) and the decision as to whether the future Eurozone countries were ready to create the EMU was driven by political forces rather that checking purely whether the economic criteria were fulfilled or not.

As Germany participated in the exchange-rate mechanism (ERM) for more than two years and during that time the Deutsche Mark remained stable, the exchange-rate criterion was satisfied. Moreover, during the reference period, i.e. from February 1997 to January 1998, the long-term interest rates were set at 5.6%, which was 2.2% below the threshold. Similarly, a rate of HICP inflation of 1.4% during that time was well below the reference value determined by the Treaty (EMI, 1998). Neither of these criteria created any problem for the economic policy of Germany. However, there were two problematic criteria.

On the one hand, in 1996 the deficit ratio of Germany exceeded the Maastricht level of 3% by 0.4% (EMI, 1998). As von Hagen and Strauch (1999) argue, it was only "accounting gimmicks", which included "special treatment for hospitals in the fiscal accounts, and one-time 'emergency' measures" that brought the deficit ratio to 2.7% in 1997. This means that the 'strict' interpretation of fiscal criteria advocated by the government in 1990s was disregarded and did not apply to the decision to create the Eurozone. *The political rationale prevailed over all economic considerations at that time* (von Hagen and Strauch, 1999).

On the other hand, what is even more striking, Germany violated the government debt criterion. The public debt reached 61.5% of GDP in 1997, which was beyond the maximum level stipulated by the Treaty. Moreover, the trend of debt after 1991 was a steady increase. After the unification of Germany the debt-to-GDP ratio increased by 19.8% between 1991 and 1997, from 41.5% to 61.5% respectively. In 1996 it was the first time when it exceeded the reference value and it rose further in the following year (EMI, 1998). The above-mentioned figures indicate that not only did Germany exceed the debt level allowed, but it also did not comply with the clause in the Treaty stating that the ratio ought to be "*sufficiently diminishing and approaching the reference value at a satisfactory pace*" (TEU, Art. 104c(b)).

As European Monetary Institute (EMI) indicates, the Convergence Programme projected the debt ratio to stabilize at circa 62% and remain above 60% until the end of the decade, which means that it clearly was not approaching the reference value, at least in short and medium term. Furthermore, the Convergence Report also stressed the need for fiscal consolidation in order to comply with the rules of Maastricht and Stability and Growth Pact (EMI, 1998). However, now we can see that Germany did not decrease its debt ratio and breached both agreements. In fact, the debt-to-GDP ratio was steadily increasing in the 21st century, reaching around 68.6% in 2005 and above 80% during the financial crisis period (Eurostat, 2013). As a result of this non-compliance -especially before the crisis- resulted in significant loss of the agreement's credibility.

The case of Germany shows that the strict EMU entrance criteria were not applied to all Eurozone countries. According to the rules, which were fully employed later, as the further example of Latvia will show, Germany should have been ruled out from the currency union. It is even odder with regard to the fact that Germany was in favour of rigorous fiscal regulations. The EMU was formed by all the Member States, which, led by Germany, breached the benchmarks set in the Treaty. Given the fact that the high standards were soon disregarded, the leading member states had already lost their credibility at the onset of the crisis and it was the Treaty that had no trustworthy defenders. As Paul de Grauwe indicates, "*the entrance criteria have very little to do with economics, and very much with politics*" (1999). Therefore, due to the fact that there was a strong political commitment among the governments to create the EMU, the criteria were applied with great flexibility and creativity at that time to make the countries 'fit'.

<u>*The case of Greece*</u>

On Jan 1st 2001, two years after failing to pass the inflation and government debt and deficit tests, Greece became the 12th country to join the Eurozone. While the Greek public celebrated EMU membership, as it was perceived as an end to a long history of economic mismanagement, investors and outside observers noted some problems. Their concerns were well founded as Greece at the time had one of the highest inflation rates in Europe and unusually high public sector borrowing (Herz, 2000).

As a result, a series of questions arises considering whether Greece genuinely managed to revamp its economy from unacceptable by EMU standards to meeting the Maastricht criteria in just 2 years or not. The first factor that sheds doubt on this rapid transformation is the fact that the country previously attempted an extensive macro stabilization in the five years 1994-1999, but was still unable to achieve sufficient transformation in time for the first round of Eurozone membership. The 1994-1999 goals were to reduce inflation from 10.8% (1993) to 3.3% (1999), lower the budget deficit by 11% from 13.2% of GDP (1994) and to manage public debt from 112% of GDP (1994) to 103% of GDP (1999). However, despite strong commitment from the ruling party and the massively popular idea of joining the EMU, which made it easier to justify economic reform, Greece was unable to achieve set goals in the five-year period. This of course brings into question the validity of the claim that the Maastricht Criteria were met in just two additional years, 1999-2001.

In its decision to allow Greece to progress on to the third stage of EMU integration (adopting the single currency) the Council, supported by reports from the Commission and ECB listed the following justifications:

- The average rate of inflation during the previous year was at 2%, below the 2.4% reference value
- The government deficit did not exceed the 3% of GDP reference value

- Government debt ratio was approaching the 60% of GDP reference value
- The country was a member in EMS' EMR and ERM II for two years, and managed to do so without devaluing the currency
- The long-term interest rate over the previous year was at 6.4%, below the reference value of 7.2%
- Domestic legislation was in line with EU norms (Greece's Membership in the single currency, 2000)

Even the reading of the Council's own decision portrays a sense of flexibility and accommodation, especially the fact that the government debt ratio was in violation of the criteria but was approaching the reference value at an (unspecified) satisfactory rate. The country's lack of genuine conformity with the Maastricht convergence criteria is even more pronounced when examined in light of mass accusations that the already non-ideal state of Greek economy was intentionally misrepresented and manipulated by the national government (Little, 2012). At that time, a strong sense existed among EU member states that Greek statistical agencies, backed by the government, used creative mechanisms of economic measurements to make the country's position seem more in line with the convergence criteria than it was.

However, despite the obvious problems, the EU looked past the shaky economic results and the means used to obtain those results and implemented an inclusive reading of the Maastricht convergence criteria. The most likely and most viable reasoning behind this inclusion is political willingness. That kind of political will seems to derive from a series of factors. Firstly, Greece willingly went through a long and difficult process of democratization and economic reform after a history of economic mismanagement and political non-cooperation (Herz, 2000). Therefore, there was a need for the EU to reward the county's behaviour. This had direct implications on the country as it showed that Greece was no longer, as Tsoukalis (1999) put it "the awkward partner" or "the black sheep" of the European family, but an equally integrated, rightful member of the EMU and more broadly the EU. The indirect political message of this inclusion to other prospective EMU members was that following EU recommendations will lead to an appropriate reward.

This leads us to the second source of political will extended towards Greece. As Greece was a kind of pilot experiment considering European periphery countries willing to adopt the euro, the aim was set for showing that with EU guidance countries could reach Maastricht convergence criteria in a reasonable amount of time. Hence, being able to portray Greece as a success story was of political interests to all EU member states. Decrypting the political message of that period on those terms, the Maastricht convergence criteria in the case of Greece were used to include a country in the EMU.

Ever since, Greece is considered to be an illustrative case of the primary role of domestic factors in the process leading up to the current economic crisis.

In more concrete terms, the Greek economy has suffered for decades from certain "endemic weaknesses", as well as systemic underpinnings that have delayed much needed structural reforms (Kalyvas, Pagoulatos, Tsoukas, 2013). Notable deficiencies of Greek economic governance include: inadequate administrative capacity; poor and inefficient intra-governmental co- ordination; excessive operational independence and low level of accountability of ministries to the core executive; flawed budget management mechanisms and weak control over public expenditure and taxation; endemic corruption, rent-seeking and clientelism; political short-termism and inadequate attention to policy reform (Spanou, 1996; Sotiropoulos, 1993; Featherstone and Papadimitriou, 2009).

Furthermore, it could be argued that these and other weaknesses of the Greek economy made it extremely vulnerable to economic crises and limited the scope for policy reform aimed at preventing and responding to recessions (Bertelsmann Stiftung, 2010). Further weaknesses would include: rigid employment laws, an underdeveloped domestic welfare system, a large "black" economy, high structural unemployment and, most crucially, high levels of public debt, non-credibility of fiscal discipline measures, low economic competitiveness and sustained trade deficits (World Bank, 2010).

Given these domestic roots of the crisis in Greece, the EMU could be said to be at fault in two major ways: in terms of failing to prevent the crisis (or limit its scope) by promoting domestic reform in Greece and in terms of responding to the crisis in a slow, uncoordinated and indecisive way. Greece is thought to have been a quite complex case spotted between its domestic economic delinquency and the systemic failure of the Euro (Panagiotarea, ECPR 2013).

Firstly, the EMU exhibits an imbalance of rules and instruments, which implies that EU rules were largely ill-suited to promote sustainable policy reform in Greece during the pre-crisis period. For instance, while formally Article 104 (now 125) of the Maastricht Treaty specified that there would be no bail-out of states in fiscal difficulty and provided for an "excessive deficit procedure", these preventive mechanisms have proven to be in practice non-credible, given extensive bailout assistance to Greece and other PIIGS economies. Moreover, the Maastricht Treaty failed to create a legal basis for the expulsion of an errant state and did not go beyond listing "broad policy guidelines" for how EU economic policy should be coordinated. In that sense, one could argue that the EMU's treaty base prior to the crisis was too vague and rudimentary to effectively incentivize member states such as Greece to comply with EU policy guidelines. This in turn significantly increased the risk of non-compliance and, coupled with the lack of an expulsion clause and other important policy measures, created a vacuum for moral hazard.

After the crisis hit Greece, another fault of EMU governance also became evident: namely, the lack of sufficient EU institutional and policy capacity for crisis management. Pisani-Ferry and Sapir (2009) and De Grauwe (2010), among other commentators, rightly criticize the striking absence of mechanisms that could have enabled speedy reaction, EU policy discretion and centralized action in response to the crisis in Greece.

Moreover, what became apparent over the course of the crisis was the largely "liberal intergovernmentalist" character of EU crisis management, as seen in the deceleration and fragmentation of the EU's policy response to the crisis by domestic constraints. Illustrative examples of such domestic constraints would be general hostility among the German public against EU assistance to Greece and equally vociferous opposition on the part of German media, both of which admittedly led to a delay of EU bailout funding to Greece (Tzogopoulos 2013, Tsoukalis 2014).

The case of Latvia

Contrary to the inclusionary approach in the case of Greece deriving from the political will aiming to the EMU expansion, the more recent case of Latvia seems to be different, having experienced a rather exclusionary approach.

Latvia has experienced tighter rules in the convergence criteria compared to the previous countries analysed. When the country joined the euro on 1 January 2014 and replaced its previous currency (lat), each point of the criteria was strictly examined and had to be fulfilled. After various rejections in the previous years, finally the European institutions reported positively in 2013. Macroeconomic levels required in the Maastricht criteria were fulfilled for the first time as well as legal requirements regarding the central bank independence. Hence, the European Union used the criteria to exclude in the case of Latvia.

For the countries, such as Latvia, that were acceded to the European Union in 2004 there was no opting out from the Eurozone. They were obliged to join the Euro as long as they had accomplished the Maastricht criteria. Thus, when Latvia joined the EU in May 2004, the adoption to the euro began. First early EU reports stated that Latvia accomplished two out of five criteria, needing to shrink inflation and stabilize the exchange rate against the euro (Commission, 2006). Though first forecasts asserted to join the eurozone earlier, at the beginning of 2008, impediments had been diverse. Firstly, the bank of Latvia argued that their economy had a completely different market cycle vis-à-vis the rest of the EU (Collier, 2007). Secondly, high growth of Latvia –annual rate of 11.3 % in the second quarter of 2007– made it difficult to stabilize prices during the 2000s (Rodionov, 2007).

Finally, the financial crisis hit the country heavily: inflation rose up to 15% in 2008, government deficit approximated to 10 % during 2008 and 2009 and also long term interest rate rose above 10 %. Latvia ran a harsh austerity program accompanying a €7.5 billion EU-IMF bail-out agreed in December 2008 (Pop, 2011). Measures raised unemployment from 6% in 2008 to 20% in 2010, and shrank to 11.5% in 2012.

In the 10-year period in which Latvia has adopted the Maastricht criteria, two indicators presented little problems for the Riga government. The first one was the public debt, accounting only for 14.7 % of the GDP in 2004. Though it had increased to 40 % in 2012, it was still below the 60 % target. Since 2005, the other indicator in which Latvia outperformed without difficulties was the exchange rate. The Latvian lat joined the Exchange Rate Mechanism (ERM II) in 2005 and was pegged to the euro at 0,702804 until the final conversion in 2014. Although the fluctuation band was 15 %, Latvia committed itself to 1 % and the lat movement against the euro did not exceed 2 % during the entire period.

The financial crisis spurred inflation, interest rates and public deficit increased severely by 2008. Driven by energy and food prices, inflation rose above 15 %, boosting the long-term interest rate to above 10 % in 2009 and 2010. Moderation by tighter credit conditions, prudent fiscal policy and wage contention shrank inflation and the interest rate under the Maastricht criteria by 2012. Latvian government needed also to stabilize high deficit, raising roughly 10 points in 2008 and 2009. Latvia undertook high austerity measures, accompanied with VAT increases, even stronger in reduced tax margins (Dreger, 2013).

By 2012 Latvian economy was stabilized into convergence standards. However, the Convergence Report of the European Commission deemed that the criteria of price stability and public finances were not fulfilled (Commission, 2012). In March 2012 annual inflation moderated to 3.2% and was expected to fall to 2.6% on average in 2012. As the criterion was 3.1 %, the Commission concluded that Latvia did not fulfil the criteria by a narrow margin. The same strict conditions were required in the public finances scheme. Latvia accounted for a public debt almost 15 points below the 60 percent required, but its government deficit was 3.5% in 2011. Although it was forecasted to fall in 2012 and 2013, the Commission applied the criteria inflexibly and also concluded that conditions were not met.

It was not until June 2013 that the Commission Report announced that the criteria were met. The inflation was 2.3 % and expected to fall to 1.4 % in 2013. The public deficit was already appropriate in 2012 with 1.2 % and expected 1.2% in 2013 and 0.9% in 2014. The Commission concluded that “if the Council decides to abrogate the excessive deficit decision for Latvia, Latvia will fulfil the criterion on public finances” (Commission, 2013). The Economic and Final Affairs Council gave the final approval on July 9th, regarding the Latvian deficit it noted that it had seen a “credible and sustainable reduction to below 3 percent of GDP by the end of 2012”. ECB and European Parliament also gave favourable statements.

Finally, Latvia also complied with the requirements for central bank independence and legal integration into the Euro system. In the Commission report of 2012, it was yet stated that Latvian legislation was not fully compatible with all adaptation requirements concerning “the independence of the central bank, the prohibition of monetary financing and central bank integration to the ESCB at the time of euro adoption” (Commission, 2012). The report of 2013 concluded that requirements were now met, although “the provision of the first paragraph of Article 43 of the Law on Latvijas Banka which requires the Parliament of Latvia to supervise Latvijas Banka would benefit from being clarified on the occasion of a further revision of its provisions to ensure legal certainty” (ECB, 2013).

It is rather clear that the Maastricht convergence criteria, although typically strict, can be applied very flexibly on a case-by-case basis. The manner in which the criteria are applied is meant to include or exclude states depending on the political circumstance and will. While in the past, the trend of the Maastricht convergence criteria application has been from inclusionary to exclusionary, we do not necessarily suggest that this trend will continue. The new EMU policy framework deriving right after the ongoing crisis demands application of the criteria despite the occasional political will, which still exists and it rather impossible that it will stop being a decisive factor. After all, no EMU expansion or deepening may be considered out of political context.

3.5 Conclusions

Each and every member state offers a valuable clue considering the interpretation and enforcement of the EMU policy framework throughout a long period of time including the crisis.

The case of Germany is an illustration of a country's fiscal landscape not being fully in line with the criteria that was still able to present itself as the political driver of EMU. It was vital for Germany to be part of Eurozone and thus the criteria were interpreted in an inclusionary manner. Another, quite different, but still inclusionary example is Greece, which was arguably least economically prepared to join the EMU, but the political importance of rewarding the country for its commitment to EU's suggestions and building a positive example for further expansion overcame the economic downfalls. Lastly, Latvia serves as an exclusionary example for the country was only slightly below the crucial reference values in application years, but the lack of specific political motivations meant that the criteria were looked at very strictly.

Those remarks may be helpful in order to light the role of the EMU governance through crisis and perhaps the manner in which the new EMU policy framework is going to be enforced. Our analysis of EMU governance within the context of crisis management in different EU countries (Spain, Italy, Germany, Greece and Latvia) shows the non-identical impact of the crisis on them and the differentiated degree of engagement with the typical rules of the EMU.

Examining the Spanish economy both before and in the aftermath of the crisis, for instance, reveals that the 'one-size-fits-all' monetary policy, as well as the lack of a common EU fiscal fund and LoLR facility within the ECB have all made the crisis for Spain more difficult to handle than it would have been in a non- EMU-membership scenario. Furthermore, these factors evidently also failed to prevent the crisis in the first place, in case we consider it to be a legitimate aim of the Eurozone framework. An identical argument could be made about other crisis economies, and our case study on Greece in particular points to several other key attributes of the EMU that may have deteriorated the crisis in that country, such as the ambiguity and incompleteness of EU treaty provisions with regards to post-crisis measures and the incapacity of the EU in general to make quick, clear and effective policy decisions in the face of domestic policy constraints.

While making this generalisation, we do recognise that the euro zone crisis is a complex phenomenon triggered by a combination of forces, including factors that originate at the domestic, rather than EU level. In that sense, although, for instance, the EU could have had a stronger position on perceived endemic weaknesses of certain economies there would not exist sufficient policy mechanisms to respond. After all, EMU was not structured as a platform aiming to take preventive measures against future economic recessions deriving mainly from incomplete domestic reforms. EMU governance should not be regarded in isolation from national/local economic governance, intra-EU national idiosyncrasies and the dominant role of states even during the current financial crisis.

Chapter 4 Reforms of the European Economic Governance Post-2010

4.1 Introduction

Having reviewed the economic governance prior to the sovereign debt crisis we have established the necessary conceptual framework in order to consider the reforms of European economic governance that have been undertaken in the wake of the onset of the European sovereign debt crisis in 2010. In response to the ongoing Eurozone crisis, a number of reforms to the EU economic governance framework have been introduced by EU policy makers. However, there has been criticism by some that these measures do not nearly go far enough on the road to complete monetary union, and that they merely represent first steps in a longer process towards adequate crisis resolution.

At first, we will investigate the extent to which this is the case, analysing what the critique for a perfect monetary union might be - including what might be considered the minimum requirements for such a union, and then presenting the reforms of the European Economic governance. This, in turn, will demand analysis of the role of the European Central Bank (ECB) and the two-tiered process of economic integration, and the political economy of economic governance in the EU.

4.2 Minimum requirements for a complete monetary union

Different theories explaining the formation of the MU hold different or even conflicting assumptions and implications. This section will first review three major theories and the minimum requirements for a complete monetary union respectively. In the end, the most fundamental and minimum requirements will be synthesized. Three major theories are mostly widely used to explain the MU (Schelkle 2013), including:

- Optimal currency area theory (OCA), which is concerned with flexibility and effectiveness in the adjustment to shocks; (for more extended analysis see chapter 2)
- Optimal control theory (OTC), which is concerned with credible commitment of monetary and fiscal authorities;
- Policy coordination theory (PC), which is concerned with the necessary coordination between policy-makers after the formation of the MU.

The conditions that are needed to make the MU attractive among member countries are summarized by the three requirements:

- Symmetry of shocks
- Flexibility of labour markets, wage flexibility and labour mobility
- Integration

However, there are many criticisms which can be directed towards OCA theory. These mainly concern the removal of national control over national exchange rates and the costs involved in doing so. Firstly, the difference between countries may not be a crucial factor. Secondly, the use of national monetary policy, including the exchange rate instrument, may not be so effective to correct the differences between nations. Thirdly, these monetary policies may not only be ineffective but even disturbing in the hands of politicians (De Grauwe 2012). Given the drawback of this OCA theory, the three minimum requirements are not as warranted.

The second theory underpinning EMU is optimal control theory, better known as “the advantage of tying one’s hands”. Delegating monetary policy to an independent supranational agency is one way for euro area Member States to credibly commit to the ‘sound finance-sound money’ paradigm underpinning the MU (Schelkle 2013). In contrast to OCA theory, this rationale for EMU gives rather precise instructions on how economic governance of a currency union should be operated. Economic governance is a basic and minimum requirement for the MU. It also provides a possible explanation for why EMU is now in crisis: the Stability and Growth Pact is not successful. The Pact didn’t prevent Greece or Italy from pursuing budgetary policies that led them to increasing level of government debt (Schelkle 2013). Indeed, it could be argued that both the OCA and OTC theories were misleading, both in terms of what was necessary to build a viable MU and in terms of what needs to be done to stabilize a MU.

In contrast to the OTC theory, the PC theory concludes that governments intend to strengthen their hands and gain additional freedom for macroeconomic stabilization through MU. MU eliminates the exchange rate as a constraint on national policies and coordination itself can be seen as an additional instrument for domestic stabilization. This theory agrees that MU should revolve around a unified monetary policy. But the current crisis suggests that a MU without a minimum level of budgetary integration doesn’t work.

According to the implications from the 3 most dominant theories and also from the recent Euro crisis, there seem to be 3 minimum requirements for a complete MU:

- Budgetary union;
- Political union;
- An enhanced role of the ECB

Based on the implications of the OTC theory, MU without budgetary union is incomplete and fragile (De Grauwe, 2012). Even though the ECB acts as the monetary authority, many national authorities each control their own budget and issue their own sovereign debt in the common currency. During the crisis, a lack of confidence can possibly drive the countries to a default in a self-fulfilling way.

According to the implication of policy coordination (PC) theory, MU must be embedded in a political union in order to work well. It is widely believed that completing the MU involves some transfer of sovereignty from the national to supranational level. Thus, completing a MU really requires the member countries to move towards more political union. Compared with the function of the Fed in the US, the ECB has not been a lender of last resort from the early beginning. This put the MU under great pressure, especially during the sovereign debt crisis given the no-bail out clause.

4.3 Reforms of Economic Governance Post-2010: Legislative and Crisis Governance

Reforms to European economic governance have occurred in two distinctive ways. On the one hand, reforms have sought to reconfigure the existing contours of European economic governance, particularly the SGP (Legrain, 2014). In particular, a new set of rules on enhanced EU governance - the 'Six Pack' - came into force in December 2011. The Six Pack has two key components.

Firstly, a reinforced SGP aims to strengthen the preventative and dissuasive facets of European economic governance. Under the new set of fiscal rules, EDPs can be launched on account of excessive debt (i.e. exceeding 60 per cent of GDP) as well as excessive deficits (Hallerberg, 2013). A non-interest bearing deposit of 0.1 per cent of GDP can be applied to a country which is placed in EDP with fines sanctioned for states that do not comply with recommendations for corrective measures (Legrain, 2014). Likewise, an interest-bearing deposit of 0.1 per cent of GDP can be imposed upon states that exceed agreed budget limitations (Hallerberg, 2013; Legrain, 2014). Thus, where previously states could openly flout fiscal rules, in the aftermath of reforms to the SGP countries are subject to punitive sanctions (Legrain, 2014).

Secondly, new requirements for national budgetary frameworks stipulate that member states must ensure that their fiscal frameworks conform to minimum quality standards (Hallerberg, 2013). Accordingly, the establishment of the Macroeconomic Imbalance Procedure (MIP) extends the surveillance of member states' fiscal policies to non-budgetary elements (Hallerberg, 2013).

The Six Pack has been buttressed by the 'Two Pack', which entered into force in May 2013 (Riso, 2013). The Two Pack stipulates that all Eurozone countries comply by the rules of the European Semester (Hallerberg, 2013). As Tuori and Tuori (2014) attest, the European Semester has been designed to ensure that macroeconomic trends are rigorously monitored in a bid to identify potential risks early and prevent a recurrence of the sovereign debt crisis (Tuori and Tuori, 2014). Between January and June member states must exchange fiscal statistics with EU institutions, after which points states are (where appropriate) given guidance as to how to improve their national budgets (Tuori and Tuori, 2014). The European Semester thus improves the recording facilities of the European Commission and ensures that fiscal rules are applied to all Eurozone member states, not solely to those countries deemed to be at risk of fiscal crisis (Legrain, 2014).

In addition, the Two Pack permits the European Commission to administer countries that are receiving financial assistance so as to prevent them from going into default (Pisani-Ferry, 2014). As a result, when countries experience severe fiscal problems they lose a significant degree of economic sovereignty, as has been the case with Greece since 2011.

Further to establishing new, tighter rules of economic governance in the guise of the Six Pack and the Two Pack, reform has also been manifest in legislation that aims to bind states to fiscal models of good governance (Legrain, 2014). Most notably, the Treaty on Stability, Coordination and Governance (TSCG), alternatively known as the 'Fiscal Compact Treaty', was signed by twenty-five European political leaders in 2012 in a bid to cement the preventative and dissuasive reforms in the Six Pack and the Two Pack (Tuori and Tuori, 2014). In particular, the TSCG aims to implement fiscal discipline by introducing a balanced budget rule in the national legislation of member states through permanent and binding provisions including:

- Strengthening the excessive deficit procedure by enshrining the 0.5 per cent of GDP structural deficit limit in the constitutions of member states.

• Introducing an Automatic Correction Mechanism (ACM) for countries in the event of significant budgetary deviations (i.e. in excess of 3 per cent of GDP) from the MTO or its adjustment path. The ACM will be triggered unless a qualified majority of Eurozone states vote against it.

• Permitting the European Court of Justice (ECJ) to ascertain whether member states have implemented fiscal rules in a correct manner.

• Ensuring greater coordination between member states. For example, member states must inform Ecofin and the European Commission when and/or if they plan to issue new debt or sell government bonds. In addition, all plans for major macroeconomic reforms must be discussed at an intra-state and supranational level.

• Holding Euro summit meetings on at least two occasions per year so as to coordinate fiscal policies between member states (Hallerberg, 2013; Legrain, 2014; Majone, 2014; Pisani-Ferry, 2014; Tuori and Tuori, 2014).

On the other hand, a system of crisis governance has been developed in a bid to address the problem of asymmetrical shock in the Eurozone. Most notably, the European Stability Mechanism (ESM) was established in 2012 as a lender of last resort for states that had been cut off from markets (Legrain, 2014). This has helped to prevent the worst affected member states from fiscal dissolution. For example, since 2010 a 240 billion Euro EU/IMF debt-relief package has kept Greece afloat (Majone, 2014). In addition to the ESM, banking reforms have sought to mitigate against the risk of contagion when banks with trans-border interests begin to falter. For example, the Single Supervisory Mechanism (SSM) creates a new system of banking supervision comprising the ECB and relevant national competent authorities (ECRS, 2013).

Furthermore, the establishment of the Single Resolution Mechanism (SRM) creates the basis for a European banking union with a 55 billion Euro central fund financed by levies imposed upon banks and credit institutions (European Commission, 2013). Advised by the ECB, the fund will be used to bail out banks that have been deemed to enter fiscal crisis. As with the SSM, the SRM is a reform that impacts primarily upon Eurozone countries although countries waiting to join the Euro can also sign up for the nascent banking union (European Commission, 2013). This is an important point to note. In particular, it should be acknowledged that where, prior to the onset of the sovereign debt crisis, there was no bailout system to rescue states whose economies were in freefall, in the aftermath of the reforms to European economic governance witnessed since 2010 member states of the European Union have a buffer against fiscal crisis (Legrain, 2014).

4.4 Evaluation of the Reforms/ Incompletion of EMU

The solvency crisis in the Eurozone has shown how much interconnected those economies are and how vulnerable they are to asymmetric shocks. So all the new fiscal agreements (i.e. Six Pack, Two Pack and Fiscal Pact) were designed in order to guarantee that all governments in both the EU and the Eurozone will behave responsibly. The notion behind the idea was that 'tying one's hands' would discourage national governments from populist and irresponsible spending. This strategy lies in accordance with the critique of De Grauwe (2012) on the 'single minded focus of the ECB on inflation (which) worked as a blind spot, preventing it from seeing that the danger did not come from CPI-inflation but from asset inflation'. In other words, the new rules are believed not only to tighten some of the already existing measures but also introduce new fiscal tools for control of financial stability in the Eurozone, something considered highly important for the completion of the monetary union.

The Six-Pack, which entered into force in late 2011, consists of five Council regulations and one directive, all based on the Stability and Growth Pact (SGP). Some interesting implications come with it, namely the preventative and the corrective arm of the SGP were revised towards stricter rules, something that is important to note since De Grauwe (2012) considered the initial SGP excessively rigid. The initial Balanced-budget rule (the preventative arm of SGP), for example, was previously setting the medium-term objectives for the budgetary position to be 'close to balance or in surplus'. This, however, was considered ambiguous, especially after the eruption of the solvency crisis in the Eurozone, and led to its revision. As a consequence, the MTOs are made more precise by giving reference values. According to the new Balanced-budget rule the budget should be either '-1% of the GDP and balance or (in) surplus'. This allows for easier control of countries breaching the rule and eventually initiating an Excessive Deficit/Imbalance Procedure, the result of which could be an imposition of financial sanctions (the corrective arm). It is believed that this will discourage unreasonable spending and so governments will be forced to have stricter fiscal policies.

Nevertheless, other rules, such as the one regarding the GDP-debt limit, still remain vague. Article 126 (2b) TFEU says the Commission should monitor *'whether the ratio of government debt to gross domestic product exceeds a reference value, unless the ratio is sufficiently* *diminishing and approaching the reference value at a satisfactory pace'*. Yet, this should not, necessarily, be interpreted as something bad. Actually, by setting an obscure debt-to-GDP criterion and a more concrete deficit-to-GDP criterion, countries are enabled to escape from the vicious circle they observe during crisis. In other words, such rules allow them to apply policy measures focused on stimulating the economy, rather than implementing austerity measures per se, while at the same time improving the original economic governance in the EU. Last but not least, one could expect that GDP-debt limit will be tightened in better economic times.

Secondly, the Fiscal Compact (2012) defines what a balanced budget and a structural deficit are. Its main purpose is to empower national governments with tools of the EU budgetary surveillance (European Commission, 2013). The reason to implement it was that not all countries were willing to follow Germany in introducing a direct constitutional debt brake. Truger and Will (2012), mention that *'taking a closer look at the movement of government bond yields over time shows that financial markets don't seem to be too impressed by the German debt brake'*. In this sense, it seems obvious to wonder whether the Fiscal Compact can have any positive effect on the EU members. In any case, it has to be tested.

The Two-Pack is another tool discussed by the Commission, the Council and the Parliament, which is supposed to increase the coordination of national budgetary processes in the Eurozone (Riso, 2013). The member states have to submit a draft of their fiscal budget proposed for next year in order for the Commission to issue statement whether it compromises the targets outlined in the Fiscal Compact or not. Although, the Commission does not have any veto power, this increases the monitoring of EDP and the euro area countries by creating an independent fiscal council.

On the other hand, it is worth mentioning the observations of Pisani-Ferry (2012) regarding countries' bond yields, according to whom *'Ireland and Spain that were never found to have infringed the rules, suffer from large spreads, whereas Germany and the Netherlands, which were found guilty of it, enjoy remarkably low rates'*. This suggests that emphasising on fiscal discipline may not, indeed, result in solving the crisis. Furthermore, if we compare countries' debt-to-GDP ratio and their government bonds yields worldwide it appears that they are not proportionally linked which means that there are also other factors which influence financial market's perception of risk. All this lead us to conclude that, although, those reforms are pertinent towards completing the monetary union, but still further steps should be taken if the aim is to achieve a complete monetary union.

4.5 The Role of ECB

4.5.1 Introduction

The role of the European Central Bank (ECB) in Eurozone crisis management remains a hotly debated issue. The ECB, responsible for the monetary policy of all eighteen Eurozone members, differs from other central banks by not acting in fiat of a single government. Additionally, its strong focus on price-stability, as stipulated in its mandate, is a key difference in relation to its American and British counterparts. The ECB is argued to be the most independent central bank in the world, with its statutes clearly prohibiting it from taking instructions from any political body in the European Union.

The role of the ECB in Eurozone crisis management has changed in recent years, most notably with the commitment by its president, Mario Draghi, that the ECB will do "*whatever it takes*" to save the Euro – de facto taking up the role of lender of last resort for governments, something which it is de jure prohibited from doing by its statutes. These developments make us wonder if the role of ECB in Eurozone crisis management is a manifestation of its supreme independence, as intended by its design, or it is de facto not as independent as previously thought.

In the first part of this section, we outline the unique design of the ECB and the apparent trade-off between independence and accountability. In the second part, we will discuss which actions the ECB has taken during the recent financial and economic crises. Lastly, we shall discuss whether this can be interpreted as a manifestation of supreme independence or de facto more dependence than initially assumed.

4.5.2 The Design of the European Central Bank

To understand how the ECB evolved, the history and circumstances of its creation must be considered. The independence of the ECB was enshrined in the treaties that established it and its design came about as the result of the economic models and the political structures prevailing at the time of its creation. Prior to the establishment of the ECB, there was political wrangling as to how to design the central bank, what its primary responsibilities should be and the degree of independence it should enjoy. The Anglo-French Model and the German Model were the two models considered when designing the bank. These two models differed greatly. The Anglo-French model granted the central bank a wide scope of responsibilities including price stability, control of unemployment and stabilization of the business cycle. While the German model (the Bundesbank model) stressed that the primary objective of a central bank is the maintenance of price stability. A way to ensure that was through keeping the central bank independent from political authorities. All other tasks were secondary (De Grauwe 2012).

During the negotiations of the Maastricht treaty, the Bundesbank model prevailed. At that time, there was an intellectual and economic move away from Keynesian principles towards a monetarist view that stressed price stability over all else and complete independence of a central bank from political pressure. Additionally, Germany enjoyed a strategic position in the process towards the creation of the EMU and the German policy focused mainly on maintaining low levels of inflation due to the risk of inflation they faced upon entering the monetary union. Thus, the ECB was created to be even more independent and more focused on price stability than the Bundesbank. The primary objective of price stability was laid-out in Article 105 and the independence was stressed in Article 107. Article 2 defined "the other objectives" of the ECB, such as high employment, but these objectives were secondary. Therefore the ECB was given political Independence with little accountability to a governing body.

The ECB is comparatively more independent than other major central banks but it has a lesser degree of accountability. The ECB can make most of its decisions, especially those pertaining to its primary mandate without any interference from political authorities. This is clearly evident in the Maastricht Treaty:

Neither the ECB nor a national central bank, nor any member of their decision-making bodies shall seek or take instructions from Community institutions or bodies, from any Government or a Member State or from any other body. (Article 130 FTUE)

It is argued that with a greater degree of independence, a central bank should have a higher degree of accountability. That is not the case for the ECB, which is often criticized for its lack of democratic accountability (De Grauwe, 2012). The European parliament cannot change the statutes governing the ECB, for it to do so it would have to change the Maastricht Treaty, which requires approval of all member states. This lack of accountability can be seen as a major problem, especially during times of crises when the ECB was forced to take on a quasi-fiscal role because governments wished to maintain fiscal sovereignty (Schelkle, 2013). The ECB is seen as unsuitable of taking on a large fiscal role, given its unprecedented degree of independence. If ECB loses its credibility, the legitimacy of the EU system would be in jeopardy. (Sibert, 2012)

During the sovereign debt crises, the ECB deviated from its original mandate of price stability and assumed a broader role that stretched into the realms of fiscal responsibility. The ECB became the backdoor to fiscal integration when it was forced to take on the role of lender of last resort and provide funds for financial assistance programmes for sovereigns such as the Troika programmes (Schelkle 2012). These actions put the ECB under pressure, especially given its lack of accountability and are in direct contrast with Article 123 of the Lisbon Treaty:

Overdraft facilities or any other type of credit facility with the European Central Bank or with the central banks of the Member States…in favour of …central governments… shall be prohibited, as shall the purchase directly from them by the European Central Bank or national central banks of debt instruments. (Article 123, Lisbon Treaty)

The ECB is independent, but only in the sense that it is free to act as it wishes within the confines of its enabling mandate – namely Articles 105 and 107 of the Maastricht Treaty. Member states can exert control and challenge ECB decisions when they think it has overstepped the boundaries of its mandate and question the legality of its actions. The ECB is not independent from politics and the member states when they are at odds with its actions. As the ECB implemented measures as lender of last resort to alleviate the sovereign debt crises, it was greatly scrutinized and challenged.

In 2011, the German appointee to the Governing Council and Executive board, Jurgen Stark, resigned in protest of the ECB's bond buying programme. Additionally, the ECB Outright Monetary Transaction programme has been recently challenged in the German Supreme Court. Thus, the ECB is not able to act in a manner which is ultra vires, as can be seen in the decision of the German Supreme Court referring the bank’s OMT policy to the Court of Justice of the European Union (Wagstyl, 2014). In reality this can be little other than evidence that the ECB perhaps remains within the grip of its member states.

The ECB’s monetary policies switched from conventional to unconventional when the zero lower bound got dangerously closer. The narrow ECB mandate led it to implement relatively few unconventional monetary policies in comparison to the entire spectrum of unconventional central bank policies (Cour-Thimann and Winkler, 2013). It was the crisis that activated a wider range of monetary policies (Cassola et al., 2010 and Fawley and Neely, 2013).

4.5.3 The (in) dependence of the ECB

As discussed in the first part of the chapter, the ECB is considerably more independent that other central banks, at the expense of its accountability. The last part of this chapter will argue why the ECB, regardless of this high degree of independence, is still subject to outside influence on its policy making – contrary to the intentions of its statutes. The focus of this argument will rely on the role of members of the ECB's Executive Board and the de facto change in the role of the ECB to a sovereign lender of last resort.

Central Bank	Alesina index	GMT index (political)	GMT index (economic)	LVAU	Eijffinger-Scaling index
Canada	2	4	7	0.46	1
ECB	4	6	7	0.81	5
Japan	3	1	5	0.36	3
New Zealand	1	2	3	0.69	3
Sweden	2	-	-	0.47	2
Switzerland	4	5	7	0.68	5
UK	2	1	5	0.53	2
US	3	5	7	0.51	3
Max. Value	4	8	8	1	5

Table 1: Central Bank Independence. Source: Weber and Forschner (2014)

For the purpose of clarity, it is important to precisely define what is meant by independence. Independence is interpreted as free from exogenous influence – which can either be political (the capacity to determine its own policy goals) or economic (the capacity to determine the instruments with which to pursue these goals). Different studies have attempted to indicate the level of independence of central banks. Weber and Forschner (2014) have analysed these indicators and the conclusion, as can be seen from the above table (1), is unambiguous. In each of the indexes used, the ECB is either the most, or one of the most, independent central banks.

While any attempt to draw conclusions based on these arguments would lead us to support the statement that the ECB is indeed supremely independent, it is necessary to expand this argument by explaining what occurred during the crisis that may have undermined its independence. The first argument we discuss is the political influence on the personnel of the ECB, and the other is the changing de facto role of the ECB during the recent crisis management.

Officially members of the governing council of the ECB – consisting of the members of its executive committee and the presidents of the national central banks of Eurozone member countries – represent the general, Eurozone interest when discussing the desired monetary policy. The reason why minutes of the Governing Council meetings are not publicly published relates to this. Without the publication of the minutes, presidents of national central banks feel free to argue for the wider interest of the Eurozone, even if this is against that of their member state and they are pressured by their governments to do otherwise. Several occasions have shown that the nationality of the executive committee member matters (Meade, 2002). Most notably, the recent appointment of the Italian Mario Draghi as president of the ECB led France to demand the resignation of another Italian member of the Executive Board, Lorenzo Bini Smaghi. According to the French, it is not appropriate to have two Italians in the six-member Executive Board with no French representation – regardless of the fact that the nationality of the board members should be irrelevant, as they should always argue in favour of the general interest of the Eurozone.

The other stream of reasoning illustrating that the ECB is not as de facto independent as previously thought relates to the changing role of the ECB in crisis management. On July 26th 2012, Draghi claimed that "w*ithin our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough.*" As discussed in the first part of this chapter, the prime objective of the ECB is price stability. With this statement, Draghi has added a possibly conflicting second objective: that of sovereign lender of last resort. If a Eurozone member country teeters on the brink of default, the ECB commits itself to rescuing the said country with an Outright Monetary Transaction programme (OMT-programme). As Weber and Forschner (2014) argue, the current ambiguity on the policy purpose of the ECB leaves the ECB exposed to possible national and European political demands.

Adding these arguments to the aforementioned research on central bank independence leads to a more ambiguous conclusion: the ECB is indeed more independent than other central banks, but at the same time, it is de facto not as independent as one would expect due to its institutional design. Its independence is undermined by the political influence on the appointment of members of the Executive Board of the ECB and by the growing ambiguity of the policy purpose of the ECB, which leaves it exposed to possible national and European political demands.

4.5.4 Conclusions

As discussed, the unique design of the ECB entails the consolidation of its de jure independence, which appears to be a trade-off with accountability. The role of the ECB differs with that of the Fed and the BoE in its approach to the recent financial and economic crisis. The ECB monetary policies have not been as aggressive as that of the Fed and BoE, with its asset purchase programmes limited to 3.5% of the Eurozone economy, relative to respectively 22.1% and 26.3% for the Fed and BoE. While this could be due to the ECB’s preference for the bank-lending channel, this programme only represents 12.1% of the Eurozone economy, which does not allow for an explanation in the huge difference in asset purchase programmes. These provide evidence of the ECB’s limited power.

When diving further into the de facto independence of the ECB, we argue that the ECB is, in some ways, more independent relative to other central banks, but the ECB is more strongly influenced by political actors than initially intended. This reasoning is supported by the influence that politicians have on the members of the ECB’s Executive Board, as well as, the changing de facto role of the ECB to a sovereign lender of last resort. This last development has added a policy objective for the ECB that is in conflict with its prime objective of price stability, subsequently, making it even more vulnerable to political influencing and pressure.

Chapter 5 Reform as a pathway to Deepening Economic Integration

5.1 Introduction

The purpose of this chapter is to evaluate whether current reforms of the EU governance framework represent pertinent steps in the completion of monetary union. We are looking in particular at whether the steps that have been taken at a supranational level are a viable means of furthering and completing economic integration. By examining the reforms of the European economic governance that have been enacted since 2010, we aim to realize the extent to which the reformist agenda has created fertile grounds for deepening economic integration..

5.2 Reform as a Pathway to Deepening Economic Integration?

Present reforms of European economic governance can be viewed as a pathway to deepening economic integration (Genschel and Jachtenfuchs, 2013). Certainly, there can be little doubt that the vastly increased modes of macroeconomic surveillance, coupled with the strengthening of the preventative and dissuasive facets of governance, have ensured that states must comply with rules that are established outside of the bounds of national governments. Furthermore, the emphasis upon constitutional legitimisation, which is a central tenet of the TSCG, effectively binds supranational governance to domestic laws, thereby addressing the historical imbalance between monetary union and economic autonomy (Majone, 2014). Therefore, while the prevailing conception of the European Union as a multilevel regulatory policy remains valid, this viewpoint fails to consider the increasing depth of the EU's involvement in the core powers of member states in the aftermath of far-reaching and unprecedented institutional and legislative reforms (Genschel and Jachtenfuchs, 2013).

However, while it is important to recognise the progressive steps that have been taken by policy makers since 2010 it is crucial to question whether these measures will have a tangible impact upon economic integration in the medium and long-term. In particular, three issues are apparent. Firstly, it is essential to highlight the role of the ECB. As Sawyer (2013) discusses, there has long been an urgent need to reform the position of the ECB. In particular, Sawyer (2013:94) suggests that it is imperative to integrate the central bank into "a set of democratic policy making procedures" (Sawyer, 2013:94). This, in turn, would ensure that while the ECB would continue to implement operational procedures (such as inflation rates), it would coordinate its policies with relevant fiscal authorities (Smith, 2013). Thus, where, at present, the ECB's primary objectives are monetary stability, the avoidance of crisis and the reduction of inflation through inflation targeting, an integrated ECB would be able to adopt a more long-term perspective upon economic integration (Smith, 2013).

Ultimately, it is immensely difficult to envisage a deepening of economic integration without greater political integration (Emmanoulidis and Janning, 2011). The lack of transparency with which the independent Central Bank presently operates runs counter to the democratic principles that underpin EU treaties. As Majone (2014) argues, in the aftermath of the nadir of the Eurozone crisis, member states and their electorates are bound to demand greater levels of transparency with regards to decisions that are taken at a supranational level. This is particularly true of the ECB which, unlike the vast majority of the institutions of the EU, has a direct impact upon the welfare of all inhabitants of both the Eurozone and the entire European Union (Majone, 2014). However, where the ECB should represent an example of the benefits of monetary union, it is instead testimony to the incomplete nature of political integration and the democratic deficit that impinges upon reforms to European economic governance (Sawyer, 2013). Thus, the problem of democratic legitimacy, a mainstay of Euro scepticism since the 1970s, remains unanswered (Mayer, 2012).

Secondly, the reforms to European economic governance have engendered a split between the twenty-eight countries that comprise the European Union. The split has occurred in two ways. On the one hand, the spate of economic governance reforms witnessed since 2010 has facilitated a split between Eurozone member states and countries that have retained their own currency yet are still part of the EU (De Grauwe, 2012). As Van Overtveldt (2011) details, the seventeen member states within the Eurozone operate on a different set of monetary and fiscal procedures than the eleven states that retain their sovereign currency. Banking regulations, resource allocation, macroeconomic surveillance, debt repayment and national budgets of Eurozone countries are all subject to supranational supervision (Van Overtveldt, 2011). More pertinently, the economic governance reforms enacted since 2010 empower Eurozone countries to act as guardians of a new fiscal order. For example, the Fiscal Compact Treaty enables a majority of Eurozone states to band together and vote against an ACM should one be activated against another member state (Hallerberg, 2013). Understood in this way, there can be little doubt that EMU states coordinate their policies and their fiscal/banking rules in a much tighter fashion than prior to 2010. This, in turn, raises significant questions as to the nature of the political union and, more pertinently, the impact upon member states that do not reside in the Eurozone (Scharpf, 2010).

Nowhere is this better illustrated than in the isolationist position adopted by the United Kingdom in response to the advent of the Fiscal Compact Treaty in 2012. With the exception of the Czech Republic, all of the EU member states had signed up for the TSCG (Legrain, 2014). However, the UK opted not to be bound by the provision of the Fiscal Compact Treaty. Additionally, the UK remains a staunch opponent of banking reforms, with the British government keen to maintain sovereignty over domestic banking regulations so as to protect the position of the City of London as a major hub of global capital (Liddle, 2014). Yet, as Beck (2014) attests, Britain's power of veto, which derives from its EU membership and has enabled London to block previous proposals, has lost its efficacy because the Eurozone states have continued to implement the reforms to fiscal governance regardless of British concerns. Unlike previous treaties, the TSCG was ratified when eleven of the seventeen Eurozone members had signed it (Liddle, 2014).

This exposes what can be understood as the emergence of a two-tier European Union constructed upon asymmetrical relationships between Eurozone and non-Eurozone countries (Van Overtveldt, 2011). Ultimately, while Britain may look to adopt a divergent path from the Eurozone countries, the economic ties that bind London to Europe (55 per cent of British exports go to the EU) ensure that British and European interests cannot be segregated (Beck, 2014; Liddle, 2014). The dissolution of the single currency would, therefore, be disastrous for the UK. Understood in this way, it is apparent that the financial crisis has only served to increase Britain's dependency upon the EU (Liddle, 2014). However, as Beck (2014:42) declares, while dependence ensures that Britain retains a keen interest in economic negotiations, "as a member only of the EU and not of the Eurozone, it [Britain] has to leave the room when it really matters." Conversely, some non-members of the Eurozone (such as Poland) may be motivated to join the single currency solely as a means of increasing their bargaining power (Beck, 2014). Thus, as Schelkle (2013) argues, the fiscal crisis has increased the economic integration of Eurozone members by default while at the same time isolating states that retain their sovereign currency.

On the other hand, it is important to acknowledge the split that has occurred within the Eurozone states. As Lapavitsas (2012) details, a growing gulf has emerged between creditor and debtor Eurozone countries. Most notably, it is apparent that debtor states have been forced to adopt stringent austerity measures and fiscal restructuring based almost exclusively upon the German economic model of development (Lapavitsas, 2012). This form of German 'euro-nationalism' has had a significant impact upon not only economic integration but also political union with staunch Eurozone members such as Italy and Spain having to restructure their finances according to German conceptions of fiscal prudency (Beck, 2014).

In addition, it is apparent that economic governance reforms have been used solely as a means of keeping some economies (such as the Greek economy) from collapsing. As Legrain (2014) observes, while the ESM was initially set up to manage the 2010 sovereign debt crisis it has since become the Eurozone's "permanent crisis-lending mechanism". Thus, the ESM is best understood in terms of an external anchor for countries prone to macroeconomic instability and market volatility rather than as a mechanism for deepening political or economic integration (Schelkle, 2013). Viewed through this prism, it can be argued that while the reforms to European economic governance have yielded high levels of regulation they have offered little by way of fiscal capacity (Hallerberg, 2013). Trapped between the logic of federalism and mutual assistance, governance reform has acted as a regulatory straightjacket that increases the dependency of debtor countries upon creditor nations (Pisani-Ferry, 2014).

As a result, it is evident that the EU has two tiers of outsiders: those countries that are EU members but not Eurozone states, and debtor countries that are dependent upon the financial aid meted out by other Eurozone countries (Beck, 2014). This is an immensely important point to note. In particular, it is crucial to acknowledge that while the reforms to European economic governance witnessed since 2010 have clearly facilitated deepening economic integration through fiscal regulation, this policy is fundamentally flawed. Not only has deepening economic integration exposed deep-seated discrepancies in the economic balance of power in the EU, it has also come at the expense of any tangible and lasting form of political integration (Scharpf, 2010). Rather, as Schelkle (2013) suggests, interventions towards fiscal integration appear as a short-term fix to much deeper demands of the European Union. If or when that crisis would be managed, there will be a quite narrow margin for decisive action aiming to long term political and economic union (Schelkle, 2013).

Thirdly, it is imperative to note that the structural deficiencies of political and economic union that have dogged the EU since its inception have not been addressed by the economic governance reforms witnessed post-2010. As De Grauwe (2012) argues, when the formerly communist state of East Germany merged with the democratic state of West Germany in 1990 monetary union occurred in tandem with political union. While the newly unified Germany adopted a common currency, unification also incorporated a range of important macroeconomic instruments such as budgetary policies, a capital transfer system, wage bargaining, social security and a coherent regulatory environment (De Grauwe, 2012). Monetary union was, therefore, forged by a political union that "came about as a result of a strong national sense of common purpose and an intense feeling of belonging to the same nation" (De Grauwe, 2012:113). This, according to De Grauwe (2012), represents the 'deep' variable that rendered both political and economic union in Germany possible after the fall of the Berlin Wall. In contrast to Germany in 1990, the European Union has historically had little by way of a deep variable in which to ground either economic or political union (De Grauwe, 2012). This, according to Jabko (2013), is an inevitable by-product of the political economy of economic governance. Where, in the German experience, politicians were united in a national sense of common purpose, in the European Union member states are influenced by the political imperatives of their domestic political arenas (De Grauwe, 2012). In particular, it is crucial to highlight the intrinsic ties that bind democratic governments to deficit and/or debt. For example, when elections approach, national governments look to cut taxes and increase spending in a bid to secure re-election (Pisani-Ferry, 2014).

Therefore, because the vast majority of economic policies remain grounded at a sovereign level (including spending and taxation, wage policies, social insurance policies, welfare systems and so forth), fiscal policies at a supranational level are relegated to mere afterthoughts of national politicians of member states (Jakbo, 2013). Thus where, during German reunification, the medium and long-term economic objectives of monetary union converged with the short-term political imperatives of political parties, in the EU the medium and long-term objectives of fiscal prudence are offset against the short-term objectives that influence democratic parties in member states (De Grauwe, 2012). Understood in this way, it is apparent that until European economic governance expands beyond the sphere of macroeconomic coordination and budgetary surveillance, the notion of deepening economic integration will remain stunted at an embryonic stage of development. The protectionist principle of juste retour thus remains the normative feature of European politics in the post-reformist era (Emmanoulidis and Janning, 2011).

5.3 Conclusions

The reforms to European economic governance that have been enacted since 2010 represent the most widespread and far-reaching changes to fiscal and monetary policy since the advent of the EMU. While, in many cases, reforms represent a strengthening of existing fiscal rules, the introduction of the Six Pack, the Two Pack and the Fiscal Compact Treaty are testimony to the European Union's willingness to tackle the causes of the sovereign debt crisis so as to prevent a reoccurrence of the economic freefall and credit collapse witnessed between 2008 and 2010. Furthermore, there can be little doubt that these reforms have had a significant effect upon economic integration. In particular, it is apparent that the increased emphasis that has been placed upon macroeconomic surveillance and the buttressing of the preventative and dissuasive arms of governance have ensured that states must comply with fiscal rules that are established beyond the bounds of national governments. Additionally, banking reforms and crisis governance have further integrated Eurozone countries into the new sphere of economic governance that has emerged in the wake of the global financial crisis.

However, it is imperative to underline the limitations of fiscal reform in the EU. In particular, it is apparent that while the reforms have deepened economic integration and fiscal coordination between countries in the Eurozone, it has engendered a schism between Eurozone states and EU members that retain their sovereign currency. Moreover, the accent upon regulation in the reformist agenda has created a split between debtor and creditor countries, with states that are dependent upon financial assistance forced to adopt a German model of economic development. As a result, it can be argued that reforms have yielded fiscal integration by default instead of creating the ideal conditions in which deepening political and economic integration can occur. The reforms to European economic governance therefore provide a short-term response to the financial crisis rather than a long-term means of deepening union between member states. The undemocratic nature of the ECB, which is both a crucial part of, yet at the same strangely aloof from economic governance reforms, further exacerbates the distinction between short-term economic integration and long-term democratic and political union.

In the final analysis, it is immensely difficult to conceive of a deepening and lasting economic integration without a significant shift towards political union. As discussed previously, this constitutes the absent deep variable that has historically impinged upon attempts at expanding and deepening integration between member states in the European Union. Consequently, it is prudent to question the impact of the changes to economic governance that have occurred since 2010. While reforms have entailed a much greater integration of the core powers of (predominantly Eurozone) member states, European economic integration has been reduced to a zero-sum equation of winners and losers, insiders and outsiders alike. This, in turn, renders economic governance reform more of a marriage of convenience than a political and economic compromise based upon a strong sense of common purpose.

Chapter 6 Fiscal policy in EMU: Rules, discretion or political incentives?

6.1 Introduction

The current economic crisis in the Eurozone has led to a heightened focus on fiscal rules at the European level to counter and prevent future crise~~i~~s. The main rationale behind this is to overcome national government profligacy and the negative externalities associated with this. In this chapter we will address whether this development can be considered as good politics or good economics and how the crisis has affected that view. The main question that we intent to answer is the degree of fiscal integration needed in order to maintain a stable and legitimate euro area.

In order to achieve this, we will outline the fiscal philosophy of the EMU and how it has changed with the crisis. Then, we will provide the arguments of why rules are necessary in the first place. Finally, we will apply Koptis and Symansky's definition of 'ideal fiscal rules' (Alves & Afonso, 2007) as a benchmark against which we will then evaluate (1) the economic and (2) the political soundness of the fiscal rules of the EMU. We will conclude by arguing that the crisis and the increased emphasis on enforcing the rules instead of applying discretion has not resulted in good economics. However, it can be considered as a necessary step in the direction of good politics, but by no means a sufficient one.

6.2 The fiscal philosophy of the EMU

Before the economic crisis, the most important fiscal rule was the Stability and Growth Pact (SGP). It established a maximum budget deficit of 3% of GDP and a government debt target of 60% of GDP. If a member state violated this rule, the country would enter into Excessive Deficit Procedure (EDP) and be subject to sanctions (De la Dehesa, 2012). However, because there was a stigma among member states not wanting to punish other governments, Germany and France breached the SGP in 2003 without sanctions. Hence, SGP lost its credibility. Additionally, budget monitoring was left to member states. Even though Greece had a debt to GDP ratio of 90% when entering the EMU, it was deemed to be reducing this ratio at a satisfactory rate. However, until 2009 Greece was misreporting on its data, allowing it to run further deficits.

As a reaction to the Greek crisis, the fiscal philosophy of the EMU can be seen as considerably tightened fiscal supervision while trying to facilitate corrective action in case of government overspending. The most important reforms are the Six Pack (including the macroeconomic imbalance procedure), the Two Pack and the European Semester.

The Six Pack ex ante tries to prevent any violation of the SGP through the definition of country-specific medium term objectives (MTOs) and their evaluation and possible adjustment to changing circumstances. Ex post, it facilitates enforcement of the EDP through reverse majority voting principle, thereby trying to increase the SGP's credibility. However, the fines will not be applied in case a country experiences exceptional circumstances, e.g. a natural disaster or a decline of their GDP of more than 2% during one year (De Grauwe, 2012). Additionally, national statistical authorities are audited by Eurostat and punished for fraud. The macroeconomic imbalances procedure tries to enhance the competitiveness of countries through the assessment of macroeconomic variables via a scoreboard. However, governments cannot directly affect the indicators and credibility is low due to a lack of enforcement.

Next, the Two Pack strengthens the EU monitoring of national budgets. The focus is not only on the quantitative side of the budget but also at the qualitative side. The European Parliament can give warnings, even if governments are within the 3% boundary.

Lastly, the European Semester allows the Commission and the ECOFIN Council to scrutinize member states' budgets before they go to national parliaments. The idea is to reduce moral hazard and receive as a preventative measure outside advice from experts on national policy.

6.3 The arguments regarding strict(er) rules and national discretion

There are some arguments that can be made in favour of using and enforcing strict fiscal rules. First, adhering to fiscal rules is necessary to prevent moral hazard. They can be seen as a disciplinary mechanism against member states' governments to prevent office-motivated incumbents overspend at the cost of the union. As the case of Greece revealed, there is a sincere risk of negative spill overs within the Eurozone. The possibility of Greece defaulting on its outstanding debt led to a market panic which resulted in a contagion effect onto other countries.

The reason is that financial markets are not efficient and cannot differentiate between the debt level of one country and that of another. All of a sudden, the market perceived a considerable risk of default also in countries such as Spain, Ireland, Italy or Portugal. Therefore, the overspending in Greece forced other countries to implement more deflationary policies (De Grauwe, 2012).

Second, the 'back against the wall' rationale, argues that hard budget constraints facilitate government reforms of the labour market. The underlying reasoning is that fiscal restrictions raise the awareness in times of crisis that the status quo is not possible to pursue further. This in turn will weaken the opposition, namely unions, and facilitate reforms that lower the equilibrium unemployment rate by counteracting increasing wage levels (Mabbett & Schelkle, 2007).

There is one important counter-argument that can be raised against the strict enforcement of fiscal rules. Not giving governments any margin to manoeuvre has resulted as in the case of Greece in fraudulent misreporting or member states using what De Grauwe (2012) calls 'creative' accounting techniques. What is meant is the selling of government assets, such as buildings, and the subsequent leasing back of them. Governments achieve in the short-term clean budgets but in the long-term hurt their country. Therefore, it can be argued that to increase the credibility of the fiscal rules in fact results in the budget numbers being less reliable (De Grauwe, 2012).

During the past years, several studies have concluded that tighter national fiscal rules coincide with a higher budget balance, more ambitious fiscal planning, and better implementation (Debrun et al., 2008; Beetsma et al., 2009). Nowadays the forth mentioned remarks have resulted in a global trend regarding international organisations, such as the European Commission, IMF etc., that advise quite regularly countries to improve their national institutions as part of wider programs to improve fiscal discipline. If we take into account that institutional reforms provide countries with fiscal discipline, it is worth mentioning that actual reforms in fiscal governance have progressed rather slowly within the euro area.

The literature indicates that ultimately policies and institutions can only be maintained provided that they reflect deeper social preferences (Debrun and Kumar, 2007). On the contrary, consolidation relying on short-term, revenue-focused policy measures provides only temporary budgetary relief, capable of exhibiting nominal convergence to the external constraints (EMU policy framework) but it is characterised by uncertain sustainability (Pagoulatos and Blavoukos, 2008).

Furthermore, actual policies and institutions reveal underlying preferences of fiscal policy makers that consist a rather convincing explanation to our understanding as to why some countries follow different fiscal strategies than others. The underlying preferences for fiscal rules versus discretion has not yet been released evidently due to their multi-parameter nature. The ongoing debate on the EU fiscal rules provides a wide range of relevant information on positions taken by different countries regarding the direction of the EU fiscal rules.

The treatment of member states in a completely different way before and after entering Eurozone may have played an important role as well, meaning that pre-accession conditionality is not symmetrical to the (soft) negative, post-accession one. For example, successful adjustment to the pre-accession conditionality brought about the prize and benefits of Eurozone membership (common currency, monetary stability, etc). Failure to conform to post-accession conditionality, as expressed by the SGP rules, would not result in the suspension of these benefits or necessarily in any other kind of cost.

The crisis management does not provide us with a consistent message about the underlying preferences that may (at least to some extent) drive both fiscal outcomes and institutional reform. European governments despite their temporary character define in a crucial manner the future of the European Union, since intergovernmental power balance influences the political aspirations of each Member State in the integration process and the coalition-building decisions especially when it comes to budget negotiations concerning mainly southern countries (Pagoulatos and Blavoukos, 2011).

Even if we think of a technocratic European Union being better than a German Europe, since its rules would be identically applicable to everyone and would be enforced impartially, the centralisation of powers and democratic deficit would remain (Legrain, 2014). The amount of national discretion needed in order not to undermine the fundamental principle of democracy needs to be defined given the recent past. Fiscal discipline is as much needed as democratic decision making.

Many countries have attempted to counter the deficit bias by adopting fiscal rules that typically set a limit to their annual budget deficits. The results are not satisfactory. Rules are either too lax or too tight and then ignored or even worse “respected” through false evidence. There is a suggestion that promotes inflation targeting central banks and asks for independent and accountable Fiscal Policy Committees, given the task of achieving debt targets and the authority to decide annual deficits, will be free from the deficit bias (Wyplosz, 2005). This proposal is attempting to balance between discretion in the short run and efficient delivering debt sustainability in the long run.

The current trend within European Union seems to be a Germanic Eurozone with a technocratic edge (Legrain, 2014). Even if that is not the worst scenario Eurozone could experience, there are definitely more desirable ones. A flexible Eurozone for now would be a realistic way of combining the political and economic flexibility needed for the Euro to thrive with an overarching framework to hold it together and a steady direction towards a fiscally-federal Eurozone as the best long-term option.

6.4 Assessing the fiscal rules from an economic perspective

In this part we will evaluate if Koptis and Symansky's four economic requisites for the so-called "ideal fiscal rules" (flexibility, adequacy, consistency and efficiency) have been taken into account in the structural reforms that Greece was asked to implement. Greece is chosen on the grounds that it was the member state where euro-crisis started and mainly developed. The events in Greece defined to some extent the way fiscal rules were reviewed and the new EMU architecture was structured. Before moving on, we shall elaborate on the reasons that made Greece became the most troubled country in the Eurozone facing the scenario of Grexit" (Buiter and Rahbari, 2012).

Since the adoption of the Euro in 2001, Greece did not implement adequate fiscal policies aimed to tackle its internal deficits (falling competitiveness, current account deficit, tax noncompliance, widespread cronyism and an inefficient public administration). Moreover, with the introduction of the Euro, Greece's borrowing costs fell from a 20% on a 10-year government bond at the end of 2000 to only 4% in 2005. Yet this extra cash was not used to enhance its fragile economy but rather to finance private consumption and more social expenditures (Blyth, 2012). At the end of 2009, the report of Finance Minister Alogoskoufis on the real fiscal situation of Greece revealed the truth regarding the budgetary data. After the appropriate statistical revises, the EU realized that the real Greek deficit was not 6%-8% but over 15% of the GDP, the highest deficit for any EU country in 2009. Consequently, financial markets immediately lost confidence on Greece's capacity to pay its own debts and all rating agencies downgraded Greeks' bonds to a "junk" status. That inevitably led to an unsustainable rise of Greek bond yields in 2010.

In order Greece to receive a first three-year €110 billion loan from the EU/IMF, there was certain conditionality to be fulfilled. The Greek government agreed on implementing a series of structural reforms and austerity measures, which aimed to remodel both the welfare and economic system of the Greek state. In order to certify whether that conditionality remains in accordance with the Koptis and Symansky rules, we will evaluate the economic reforms implemented in Greece in terms of flexibility, adequacy, consistency and efficiency.

In terms of "flexibility", all the implemented reforms do not seem to be able to definitely protect the country from further and future exogenous shocks or bringing the situation back to the authorities' control. Greece's public debt ratio is expected to reach 120.5% of GDP only by the end of 2020 (Eurogroup Statement, 2012). The public debt including collateral forecasted for 2014 is 190.9% of the GDP (European Commission, 2011). The public finances of Greece might still be considered too vulnerable in the future and exogenous shocks might still affect the country. The Eurozone still has a high and alarming public-sector debt burden and, "unless something is done to solve the stock overhang problem", further austerity measures will be needed (Buiter, 2014). Hence, the reforms do not fulfill the "flexibility" criterion.

In terms of "adequacy", the new stricter set of fiscal rules implemented in Greece have achieved their most important goal: change its deep negative primary deficit in Q2 2013 (-12%) to a small but encouraging surplus at the end of the Q3 of the same year (ECB - Statistical Data Warehouse, 2014). However, achieving some specific objectives might create dramatic tradeoffs amongst policy-makers. If, on the one hand, "Fairness and efficiency have inter-temporal and intergenerational dimensions too, so public debt, which redistributes the burden of funding public spending over time, across generation and between different stakeholders within a generation – plays a critical role in meeting many of today's financial challenges" (Buiter, 2014), on the other hand, the approach described as 'balanced budget fundamentalism' (De la Dehesa, 2012) is strongly related with high levels of unemployment (Greece's rate is currently 28% - 61.4% for those under the age of 25 – and it is expected to rise further in the first quarterly of 2014) and a perilous general discontent. It appears that the "adequacy" criterion is not met either.

In terms of "consistency", fiscal reforms in Greece have been going hand-in-hand with other macroeconomic policies. The austerity measures changed the Greek welfare system radically.

To reduce the public expenditures, Christmas bonuses have been abolished, the pension system has been reformed by increasing the retirement age from 61 to 65, by introducing a contribution-related proportional system and a basic pension of €360 (Matsaganis, 2011). Moreover, concrete jobs cuts affected the public sector (at least 150,000 before the end of 2015), both the health and defence sectors have gone through budget reductions, more than 100 closed profession have been liberalized. The lack of labour competitiveness and the high labour cost have been partially resolved by reducing the national minimum wage (-22%) and by creating incentives for a more flexible collective bargaining system (firm level agreements rather than centralized and professional ones). Also working time arrangements and obligatory rest hours are less rigid compared to the past (Greek Ministry of Finance, 2013). The fiscal reforms imposed on Greece can therefore be deemed as fulfilling the "consistency" criterion.

In terms of "efficiency", sever and self-committing fiscal rules could be seen as chance to restore competiveness and credibility as well as ensure the sustainability of the budget. Undoubtedly, higher levels of productivity require concrete structural reforms. Arguably, the "efficiency" criterion is achieved, however, changes only at a national level might be not enough. The EU still needs important reforms if it wants to empower its monetary union. Some important step forwards have been put in place, but in terms of integration, flexibility and symmetry much more is required to be done.

This is the reason why we argue that the economic reforms put forward in Greece only partially respond to those criteria that Koptis and Symansky defined as essential for good economics. For the policies to become good economics, most importantly the "adequacy" criterion needs to be fulfilled. This could be achieved by lowering the austerity requirements to assure space for structural reforms. A new paradigm of helping instead of punishing would also facilitate Greece's to return to competitiveness and growth.

6.5 Assessing Fiscal Rules from a political perspective

Also the political quality of fiscal rules prescribed within the EMU will be assessed along the dimensions identified by Kopits and Symansky (1998). They understand politically democratic rules as 'good politics', when they are clearly defined, transparent, simple and enforceable. Schuknecht (2004) agrees that there are potentially 'vested interests' in complex rules; politicians may prefer complexity because this renders manipulation easier and implementation difficult. Simplicity is consequently regarded as the democratically viable approach which ensures that the public is as informed as possible.

Using these four properties, based on the aforementioned elaboration of the SGP, we conclude that before the crisis this rule was quite clear and simple. Unfortunately, it lacked transparency due to national supervision of budgets. The lack of sanctions imposed through EDP was a clear indicator that the rule was not enforceable. Therefore, the initial SGP cannot be considered as 'good politics'.

To determine what constitutes good politics we further consider two additional criteria: 1) Politicians' motivations in the pre-crisis phase and 2) Economic performance in the aftermath of the Eurozone crisis. We find that at the time of the creation of the EMU, rules facilitated the fulfilment of national objectives and drove political will to 'complete' the union. In the aftermath of the crisis, however, it became clear that sub-optimal economic outcomes were an indication that the lack of enforcement supportive measures constituted bad politics at a European level.

6.6 EMU Arrangements: The battle between national and European politics

In the *pre-EMU phase*, retaining national sovereignty over fiscal policy was perceived as good national politics for states which wanted to benefit from an economic union, while avoiding the surrender of powers that comes with the completion of a fiscal and/or political union.

The stability and growth criteria during Maastricht negotiations met the political objectives of both French and German politicians. France, which had experienced multiple exchange rate crises until 1992 (Sandholtz, 1992), needed a new monetary policy framework to be implemented. The French wanted to contain Germany's power. Good national politics in France dictated that replacing the Bundesbank with an 'EU clone' was better than allowing the Bundesbank to dominate (Moss, 1998). The German rationale for requesting fiscal rules as a condition for participation in the EMU had to do with protecting the German economy from inflationary pressures. The Maastricht Treaty and the SGP went hand-in-hand with the creation a European Central Bank modelled on the German Bundesbank (Torres, 2007). This clear set of fiscal rules was therefore good national politics for both the French and the German. At the same time, it underpinned a political compromise that led to the transition to EMU.

If we were to conclude that the fiscal rules that prevailed under the SGP were good politics merely because they facilitated the EMU transition, we would be missing a crucial point. Citizens are increasingly punishing political incumbents for unfortunate economic outcomes (Chwieroth and Walter, 2013). Economic performance within the framework of the Eurozone becomes an increasingly important indicator of political performance. Democracy is an ‘empty ritual’ if the democratic procedure cannot ‘achieve the goals that citizens collectively care about’ (Scharpf, 1999). Given the ex-post outcomes of the Eurozone crisis, we can now argue that opting for ‘rules rather than discretion’ in the absence of broader fiscal coordination has always meant bad politics at a European level (Schelkle, 2008).

Although this rule may have served national interests successfully at the time of EMU creation, they proved a suboptimal political strategy for the Eurozone vis-à-vis the rest of the developed world. The rules allowed some countries (Blankart, 2013), i.e. those running permanent budget deficits and inflation, to externalize their deficits on other Member States. Moreover, these ‘disciplinary’ rules led Member States to fatally postpone the creation of insurance for governments running into fiscal difficulties (Schelkle, 2008). That practically means that because of the EMU there have been created a series of country categories with certain characteristics clearly non-integrated.

The inherent credibility problem associated with policymakers’ anticipated attempts to boost employment by increasing inflation was not solved (Schelkle, 2008). The rationale for tying governments’ hands through rules can be traced back to perverse political preferences and electoral objectives (Muscatelli, 1997). This is a classical principal-agent problem: governments act as an agent of the median (European) voter (Drazen, 2000), but do not share the principal’s priority of economic stabilisation. The fiscal rules of the EMU no matter how advanced after the crisis do not necessarily increase credibility. Although the fiscal philosophy of rules may end up as a good economic policy, it may still be ‘bad politics’ (Buti and Noord, 2004). In their research of Buti and Noord there was found that EMU’s fiscal policy framework had done little by 2004 to curb the resurgence of electoral budget cycles and that was thought to be the consequence of a weak system of sanctions and incentives. Concerning the credibility problem, inflation rates may have been reduced, but governments just used different ways to keep employment levels at super-natural levels (Pisani-Ferri, 2002).

The crisis brought to light –things that were already known- that most countries did not fulfil their stability programmes, that the SGP did not encourage fiscal coordination and that there was no coherence between counter-cyclical fiscal policies and expansionary monetary policies (Alves and Alfonso, 2005). There was a strong focus on national budgets and little assessment of the aggregate fiscal position of the euro area, as suggested by the traditional theory of policy co-ordination (Schelkle, 2008). The lack of law enforcement which remained the status quo for many decades simply meant that countries relied on reputational costs as a sanctioning mechanism (Schuknecht, 2004. The reason why there was no strict adherence to rules goes back to the idea that when there is a lack of urgency, office-motivated politicians have little incentives to move in the uncertain direction of policy reform (Schuknecht, 2004).

It is only in this post-crisis phase that European leaders have begun to realize that strict fiscal rules require enforceability. Therefore, the reforms are a step in the right direction (more transparency and enforceability) but the effect remains to be seen. Therefore, the strict framework that will be enforced without exceptions and soft-law approaches is most likely to advance European integration – at least among the members of the Eurozone.

6.7 Conclusions

We conclude that prior to the crisis, the SGP proved not to be a good policy from neither an economic nor a political perspective. Examining the fiscal philosophy of the EMU after the crisis, the increased monitoring and enforcement of fiscal rules on the one hand achieve to overcome moral hazard and negative spill-over effects. On the other hand, the lack of discretion complicates structural reforms due to fiscal boundaries for governments in economic crisis repeating the old and unsuccessful recipe of the "one size fits all". Therefore, it still cannot be considered as good economics.

Looking at the new rules adopting a rather political perspective, it can be said that by overcoming the lack of transparency and enforceability of the previous framework, these rules are a step closer to the right direction. Even if that is true, there still needs to be a change in mind-set to complement the decisions made through further integration, such as a budgetary union. This will help overcome the sub-optimal outcomes at a European level and result in better politics for the union as a whole.

Chapter 7 Closing Remarks

The ongoing crisis seems to be responsible for the birth of a crypto-union. In the course of the Euro area crisis the EU has made decisive steps beyond the regulatory polity and towards fiscal integration. Thanks to the current EMU arrangements there exist elements of a fiscal union through the backdoor of monetary policy. Although many have severely criticized the procedure followed in order to reach that point, they seem to neglect the fact that it was the initial distinction of fiscal and monetary policy that inevitably led to that paradox (Schelke, 2012).

The economic constitution of EMU was based on the historical separability between fiscal and monetary authorities (Goodheart, 1998). Despite pressures for greater monetary policy activism, price stability was the one and only priority of the monetary policy. Even though the demands of those times were imperative, the member states attempted to avoid fiscal integration and ECB was reluctant to accept the prominent role of lender of last resort to sovereigns. Governments were not ready to commit to anything more than limited emergency funds, so the markets remained nervous and panic was (almost) spread. Thus, ECB felt obliged to accept a politically salient fiscal responsibility, which is definitely difficult to be combined with the status of independent central bank.

Fiscal integration by default is the result of trying to maintain budgetary disintegration against economic functionalist imperatives of stabilizing integrated financial market (Schelke, 2012). The paradox lies in the fact that the current fiscal integration was achieved through the severe attempts of some member states to prevent any further fiscal integration. Fiscal Integration is a reality to a certain extent.

The European Monetary Union as constructed remains rather a risk pool than an insurance mechanism. The European integration achieved mainly by default rather than by design is important but not sufficient enough to lead the European Union to the next level of integration.

The current Economic and Monetary Union (EMU) is an incomplete monetary union because the member states in Eurozone are holding their own control over fiscal policies such as planning independent budget plans and issuing government debts. The fragility arises because the member states are subjected to default risk when confronting a solvency shock. To eliminate the fragility further steps are necessary.

Instead of accelerating the movement towards political union as it was initially intended to, EMU has made differentiated integration unavoidable. That means that there exist different variations regarding the application of European policies and the intensity of participation in European policy regimes (Wallace, 1998). The multi-speed Europe (Tindemans, 1975) is absolutely present and each (group of) member-state(s) move(s) towards deeper integration at different speed.

Instead, European Union has been divided into many distinctive groups: the members of the euro zone and those to lenders and creditors; the de jure (UK, Denmark) and de facto (Sweden) opt-outs; and the member states waiting to be admitted to the euro zone. The range of the country groups becomes even wider if we take into account possible drop outs of the Eurozone (Rogoff, 2006).

The minimum requirements for a complete union are not achieved. Completing the monetary union means eliminating all current sources of fragility (De Grauwe, 2012). A major element of fragility is the existence of national public budgets and national public debt (De Grauwe, 2012). Member States having transferred monetary policy but not their fiscal policy to the EU level, they are made more vulnerable to liquidity and solvency crises. Indeed, they issue debt in the common currency over which they have no direct control. If investors start massively selling bonds following a movement of distrust, Member States in a monetary union cannot create the liquidity to pay out the bondholders as they would if they had kept control over monetary policy, making them more vulnerable to solvency crises.

Based on this analysis, a complete monetary union requires budgetary consolidation, i.e. the combination of national budgets and debts into a single entity (De Grauwe, 2012). A budgetary union would bring the fragility identified earlier to an end in two ways. First, unifying national budgets into a common budget at EU level would reduce the impact of asymmetric shocks on the Eurozone. With a central budget, automatic transfer mechanisms would provide resources to countries facing an asymmetric shock from countries in a better economic situation. Fiscal transfers considerably increase the optimality of a currency area by mitigating the impact of asymmetric shocks. According to the Optimal Currency Area (OCA) theory, 'countries that agree to compensate each other for adverse shock form an optimum currency area' (Baldwin & Wyplosz, 2012). Secondly, consolidating national debt into a single debt at Eurozone level managed by a common fiscal authority would make it possible for such a common fiscal authority to issue debt into a currency it can control, thus weakening the problem of Member States' vulnerability to liquidity and solvency crises (De Grauwe, 2012).

These two lines of reform amount to implementing a fiscal union, since fiscal policy, namely tax policy, expenditure policy as well as debt management (Wildasin, 2002), is at least partly transferred to the EU level. A fiscal union is therefore a necessary requirement for completing the eurozone (De Grauwe, 2012; Pisani-Ferry, 2012).

The degree of fiscal union necessary to achieve a complete monetary union however remains to be determined. A full budget and debt mutualisation at the EU level would create a sustainable monetary union. However, it is not a politically plausible option as it goes against Member States' preferences and it also exceeds the minimum requirements necessary for achieving a complete monetary union. A lesser degree of budgetary and debt consolidation could suffice. For instance, transferring some fiscal powers to the EU by enabling it to raise taxes, would be enough to reduce the impact of asymmetric shocks. We can also imagine a lesser degree of debt consolidation in the form of introducing common bonds. The so-called 'Eurobonds', so far rejected by Member States, would mutualise debt at EU level, making all Member States jointly responsible for their debt (De Grauwe, 2012; Pisani-Ferry, 2012).

Such a 'banking federation' (Pisani-Ferry, 2012), implying EU-level supervision and bail-out of systemically-significant banks, would reduce the vulnerability of Member States to banking crises. The solutions we put forward to complete the monetary union require 'some transfer of sovereignty from national to supranational institutions' (De Grauwe, 2012), such as the common fiscal authority. If we define political union as centralized decision-making (Hodson, 2009) in democratic supranational institutions, it becomes clear that the completion of a monetary union requires further political integration through more centralization of powers (Goodhart, 2011). In other words, a complete monetary union is a monetary union 'embedded in a political union' (De Grauwe, 2012).

Several conclusions can be drawn for this analysis. Firstly, even though the ECB has been involved as a quasi-fiscal role to provide liquidity to peripheral countries and to launch indirect bond-buying programme during the current crisis, the ECB is still not qualified as a lender of last resort for the national banks. Its surrogates, EFSF and its permanent successor ESM raise funds from the shareholders and will not be able to guarantee an unlimited liquidity provision, furthermore, the conditionality follows with the mechanisms restricts the liquidity provision hence affects the effectiveness of the rescue action. Therefore, we argued that a role of a lender of last resort played by the ECB is necessary and also one of the minimum requirements for completing a monetary union.

Second of all, the fiscal policy measures, which were introduced, namely the Six-Pack, Fiscal Compact and the Two-Pack, are considered important for the economic coordination and the macroeconomic surveillance of the euro area members. The reason is that fiscal consolidation implies reduction of asymmetry between countries, thus limiting the chance for further shocks. Even more, it prevents from moral hazard issues, which is a considerable problem for completing a monetary union. However, there is evidence that fiscal discipline may not be the only solution to the Eurozone crisis, thus further steps are required for achieving a full monetary union.

Last but not least, a complete monetary union requires a budgetary union. Fiscal capacity at EU levels in turns allow for the establishment of a banking union. We have concluded that such minimum requirements amount to furthering the process of political integration since they entail an increased centralization of decision-making in supranational institutions. In other words, further political integration is necessary to achieve a sustainable monetary union.

There is a wide consensus that a political union is necessary to secure the monetary union. According to De Grauwe, further European integration process, especially building a political union will be the ultimate solution toward the current fragility of the EMU. There does exist fiscal integration by default, but economic integration demands further political integration.

The reforms of economic governance might be pertinent steps towards the completion of the monetary union to some extent, but they are not sufficient steps. There is little evidence that a more concentrated political union is possible in near future – no matter how desirable or necessary that is. The spirit of common interest which is absolutely necessary for a political union to be built is still absent in Europe.

References

Alves, R.H. and Afonso, O. (2007), 'The "new" stability and growth pact: more flexible, less stupid?, Intereconomics, Vol. 42, Issue 4, pp. 218-225

Annett, A. (2006) Enforcement and the Stability and Growth Pact: How Fiscal Policy Did and Did Not Change Under Europe's Fiscal Framework: IMF Working Paper New York: International Monetary Fund

Baldwin, R. and Wyplosz, C. (2012) The Economics of European Integration: 4th Edition London: McGraw Hill

Baun, M. J. (1995). The Maastricht Treaty as High Politics: Germany, France, and European Integration. Political Science Quarterly

Beck, U. (2014) German Europe Cambridge: Polity Press

Beetsma, R., M. Giuliodori and P. Wierts (2009), Planning to cheat: EU fiscal policy in real time, Economic Policy

Blankart, C.B. (2013). Oil and Vinegar: A Positive Fiscal Theory of the Euro Crisis, CESifo Working Paper Series No.4426, Munich: CESifo.

Blyth, M. (2013), Austerity: A history of a dangerous idea, Oxford University Press, USA

Buiter, Willem H. 1999. "Optimal Currency Areas, Why Does the Exchange Rate Regime Matter?" Scottish Economic Society Annual Lecture. Edinburgh. October.

Buiter, W. and Rahbari, E. (2012), "Rising Risks of Greek Euro Area Exit", Citi Economics, Global Economics View, 6 February 2012

Buiter, W. (2014), Why fiscal sustainability matters, from Voxeu.org

Cassola Nuno, Durre Alain and Holthausen Cornelia, Implementing Monetary Policies in Crisis Times: the Case of the ECB/Eurosystem, (12th November 2010) URL: http://www.ecb.europa.eu/events/conferences/html/cbc6/Session_5_paper_Cassola_Durre_Holthausen.pdf?97ec6fff36f3a1e4ef9902feef6adf59

Chwieroth J. F. and Walter A. (2013), Banking Crises and Political Survival over the Long Run - Why Great Expectations Matter. Available at: http://www.voxeu.org/article/banking-crises-and-political-survival-over-long-run

Collier, M. (2007) Bank targets 2013 as Latvia's E-day. Retrieved March 1, 2014, from The Baltic Times website http://www.baltictimes.com/news/articles/19151/#.UxIBLM4eqbQ

Cour-Thimann Philippine and Winkler Bernhard (2013), The ECB's Non-Standard Policy Measures: the Role of Institutional Factors and Financial Structure, ECB Working Paper Series URL: http://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1528.pdf

De Grauwe, Paul (2006) "What Have We Learnt about Monetary Integration since the Maastricht Treaty?" Journal of Common Market Studies 44: 711-730.

De Grauwe, P. (2010) 'The Greek Crisis and the Future of the Euro-Zone'. Eurointelligence. Available at: http://www.eurointelligence.com

De Grauwe, P. (2011), 'A Fragile Eurozone in Search of a Better Governance', CESifo Working Paper No. 3456, Munich CESifo.

De Grauwe, P. (2012) The Economics of Monetary Union Oxford: Oxford University Press

De Grauwe, P., and Ji, Y., (2013) 'Self-fulfilling Crises in the Eurozone: An Empirical Test', Journal of International Money and Finance, Volume 34, April, Pages 15–36.

De Grauwe (2013), Design Failures in the Eurozone: Can they be fixed? [online], LSE 'Europe in Question', Discussion Paper, Available from: http://www.lse.ac.uk/europeanInstitute/LEQS/LEQSPaper57.pdf

De la Dehesa, G. (2012), A Self-Inflicted Crisis? Design and Management Failures Leading to the Eurozone Crisis, Occasional Paper No.86, Washington DC: Group of Thirty

Drazen, A. (2000) Political Economy in Macroeconomics, Princeton, NJ: Princeton University Press

Dreger, C. (2013) Accession of Latvia to the European Monetary Union. Conference in the German Institute for Economic Research, April 2013 http://www.riga.diplo.de/contentblob/3868716/Daten/3203029/2013PraesentationDreger.pdf

Debrun, X. and Kumar, M. (2007), The discipline-enhancing role of fiscal institutions: theory and empirical Evidence, in The role of fiscal rules and institutions in shaping budgetary outcomes, European Commission Economic Papers, No. 275, European Commission, Brussels

Debrun, X., L. Moulin, A. Turrini, J. Ayuso-Calsals, and M. Kumar (2008). Tied to the Mast? The Role of National Fiscal Rules in the European Union, Economic Policy

European Parliament. (2012). 'The role of the ECB in Financial Assistance: Some Treaty on the Functioning of the European Union (TFEU), Title VIII: Economic and Monetary Policy, 2007. URL: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2010:083:0047:0200:en:PDF

EMEA Centre for Regulatory Strategy (ECRS) (2013) The Single Supervisory Mechanism (SSM): Stronger Together? London: Deloitte

Emmanoulidis, J.A. and Janning, J. (2011) Stronger After the Crisis: Strategic Choices for Europe's Way Ahead Brussels: European Policy Centre

Eurogroup Statement on Greece, 27 November 2012

European Commission (2013) 'Banking Union: Single Resolution Mechanism (SRM).' In European Commission [online], available at, http://ec.europa.eu/internal_market/finances/docs/banking-union/dg-markt-factsheets-srm_en.pdf (last accessed 15.09.14)

European Monetary Institute (EMI) Convergence Report: Report required by Article 109j of the Treaty establishing the European Community, http://www.ecb.europa.eu/pub/pdf/conrep/cr1998en.pdf

Eurostat (2013). Government ¬finance statistics http://epp.eurostat.ec.europa.eu/cache/ITY_OFFPUB/KS-EK-13-002/EN/KS-EK-13-002-EN.PDF

Fawley Brett and J.Neely Christopher, Four Stories of Quantitative Easing, Federal Reserve Bank of St. Louis Review, (January/February 2013). URL: http://research.stlouisfed.org/publications/review/13/01/Fawley.pdf

Featherstone, K. and Papadimitriou, D. (2009) 'The Naked Emperor: Prime Ministerial Leadership and Core Executive Management in Post-1974 Greece'. Paper presented at the

Conference on the Challenge of Reform in Greece, 1974– 2009: Assessment and Prospects, Yale University, New Haven, CT, 8–9 May

FEDERAL RESERVE ACT, Section 2A: Monetary Policy Objectives, 1913. URL: http://www.federalreserve.gov/aboutthefed/section2a.htm

Fiscal Risk Sharing Mechanism?, International Monetary Fund, Working Paper 13/198

Frankel, Jeffery A. and Andrew K. Rose. (1998) "The Endogeneity of the Optimum Currency Area Criteria." Economic Journal 108: 1009–1025

Furceri Davide, Aleksandra Zdzienicka (2013) The Euro Area Crisis: Need for a Supranational

Genschel, P. and Jachtenfuchs, J. (2013) 'Introduction: Beyond market regulation. Analysing the European integration of core states,' in, Genschel, P. and Jachtenfuchs, M. (Eds.) Beyond the Regulatory Polity? The European Integration of Core State Powers Oxford: Oxford University Press, pp. 1-26

Greece's membership in the single currency. (2000, June 19). Retrieved March 4, 2014, from Europa website: http://europa.eu/legislation_summaries/economic_and_monetary_affairs/institutional_and_economic_framework/l25059_en.htm

Goodhart, C.A.E. (2011). 'Europe After the Crisis', Institute for New Economic Thinking

Greek Ministry of Finance (2013), Greek National Reforms Programme 2013 April

Hallerberg, M. (2013) 'Why is there fiscal capacity but little regulation in the US but regulation and little fiscal capacity in the Europe? The global financial crisis as a test case,' in, Genschel, P. and Jachtenfuchs, M. (Eds.) Beyond the Regulatory Polity? The European Integration of Core State Powers Oxford: Oxford University Press, pp. 87-104

Herz, B., & Kotios, A. (2000). Coming home to Europe: Greece and the Euro. Intereconomics, 35(4), 170-176

Hodson, D. (2009). 'EMU and political union: what, if anything, have we learned from the euro's first decade?', Journal of European Public Policy, 16 (4), 508-526

IMF (2008), Global Financial Stability Report

IMF (2009), February 2009, IMF Country Report No. 09/45, http://www.imf.org/external/pubs/ft/scr/2009/cr0945.pdf

Jabko, N. (2013) 'The divided sovereignty of the Eurozone,' in, Genschel, P. and Jachtenfuchs, M. (Eds.) Beyond the Regulatory Polity? The European Integration of Core State Powers Oxford: Oxford University Press, pp. 124-144

Kalemli-Ozcan, S., B.E. Sorensen & O. Yosha (2004) Asymmetric Shocks and Risk Sharing in a Monetary Union: Updated Evidence and Policy Implications for Europe, CEPR Discussion Paper 4463, London: CEPR

Kalyvas S., Pagoulatos G. and Tsoukas H. (2013), From Stagnation to Forced Adjustment, Reforms in Greece 1974 – 2010, Oxford University Press

Kenen, Peter B. 1969. "The Theory of Optimum Currency Areas: An Eclectic View." In Monetary Problems of the International Economy, edited by Robert Mundell and Alexander Swobada. Chicago: University of Chicago Press.

Kopits, George and Steve Symansky (1998) Fiscal Policy Rules, IMF Occasional Paper 162.

Krugman, Paul. 1993. "Lessons from Massachusetts." In Adjustment and Growth in the European Monetary Union, edited by Francisco Torres and Francesco Giavazzi. Cambridge: Cambridge University Press.

Lapavitsas, C. (2012) Crisis in the Eurozone London: Verso

Legrain, P. (2014) European Spring: Why Our Economies and Politics are in a Mess - and How to Put them Right New York: CB Books

Lelieveldt, H. and Princen, S. (2011) The Politics of the European Union Cambridge: Cambridge University Press

Liddle, R. (2014) The Europe Dilemma: Britain and the Drama of EU Integration London: IB Tauris

Little, A. (2012). How 'magic' made Greek debt disappear before it joined the euro. Retrieved March 4, 2014, from BBC website: http://www.bbc.co.uk/news/world-europe-16834815

Lopez, Claude and Papell, David H. "CONVERGENCE OF EURO AREA INFLATION RATES." Bank of France Working Papers 2011, 4

Mabbett, D. and Schelkle, W. (2007), 'Bringing macroeconomics back into the political economy of reform: the Lisbon Agenda and the "fiscal philosophy" of EMU', Journal of Common Market Studies, Vol. 45, Issue 1, pp. 81-104.

McKinnon, Ronald I. (1963) "Optimum Currency Areas." American Economic Review 53: 717-725.

Majone, G. (2014) Rethinking the Union of Europe Post-Crisis: Has Integration Gone too Far? Cambridge: Cambridge University Press

Marco. B. and Noord V. D. (2004). Fiscal policy in EMU: rules, discretion and political incentivesEuropean Commission, July 2004

Mayer, T. (2012) Europe's Unfinished Currency: The Political Economics of the Euro New York: Anthem Press

Matsaganis, M. (2011), The welfare state and the crisis: the case of Greece, Journal of European Social Policy 2011 21: 501

Meade Ellen (2002), How independent is the ECB? http://www.project-syndicate.org/commentary/how-independent-is-the-ecb-

McNamara, K.R. (1998). The Currency of Ideas. Monetary Politics in the European Union (Ithaca/London: Cornell University Press).

Moss, B.H. (1998), France: EMU and the Social Divide. In B. H. Moss, & J. Michie, The Single European Currency in National Perspective (pp. 58-79). Basingstoke: Macmillan Press.

Mundell, Robert A. 1961. "A Theory of Optimum Currency Areas." American Economic Review 51: 657-665

Pagoulatos G. and Blavoukos S. (2008) "The Limits of EMU Conditionality: Fiscal Adjustment in Southern Europe", Journal of Public Policy, 28/2, 2008, 229-253

Pagooulatos G. and Blavoukos S (2011), "Accounting for Coalition Building in the European Union: Budget Negotiations and the South", European Journal of Political Research, 50(4), 2011, 559-581

Pagoulatos G. and Quaglia L. (2013) in Iain Hardie and David Howarth (eds) “Turning the Crisis on its Head: Sovereign Debt Crisis as Banking Crisis in Italy and Greece”, Market-Based Banking and the International Financial Crisis, Oxford, Oxford UnIversity Press

Panagiotarea Eleni (2013), Greece in the Euro : Economic Delinquency or System Failure?, ECPR

Pisani-Ferry, J. (2002). ‘Fiscal Discipline and Policy Co-ordination in the Eurozone: Assessment and Proposals’. Note for the GEA meeting of 16 April (Brussels: CEC)

Pisani-Ferry J. and Sapir, A. (2009) ‘Weathering the Storm: Fair Weather versus Stormy-Weather Governance in the Euro Area’. Bruegel Policy Contributions, No. 286

Pisani-Ferry, J. (2012). ‘The euro crisis and the new impossible trinity’; Bruegel Policy Contribution 2012/01

Pisani-Ferry, J. (2014) The Euro Crisis and its Aftermath Oxford: Oxford University Press

Pop, V. (2011, September 15) Latvia aiming to join eurozone in 2014. Retrieved March 2, 2014, from the EU Observer website.

http://euobserver.com/economic/113635

Riso, S. (2013) Lessons of the Crisis: The Six-Pack, the Two-Pack, the Fiscal Compact… Steps Towards a Fiscal Union? Brussels: The European Commission

Rodionov, V. (2007, August 18) Don’t look for the Euro until after 2012. Retrieved March 1, 2014, from New Europe: the European Weekly website http://web.archive.org/web/20071223024102/http:/www.neurope.eu/view_news.php?id=76779

Rogoff Kenneth (2006), Impact of Globalisation on Monetary Policy, “The new economic geography : Effects and Policy Impllications

Sandholtz, W. (1992), Choosing Union: Monetary Politics and Maastricht. International Organization, 47 (1), 1-39

Sawyer, M. (2013) ‘The problematic nature of the economic and monetary union,’ in, Fadda, S. and Tridico, P. (Eds.) Financial Crisis, Labour Markets and Institutions London: Routledge, pp.79-97

Scharpf, F.W. (2010) ‘The asymmetry of European integration, or why the EU cannot be a social market economy,’ in, Socioeconomic Review, 8(2): 211-250

Schelkle, W. (2013) 'Fiscal integration by default,' in, Genschel, P. and Jachtenfuchs, M. (Eds.) Beyond the Regulatory Polity? The European Integration of Core State Powers Oxford: Oxford University Press, pp. 105-123

Sibert A. (2012), The Role of the ECB in Financial Assistance Programme, Directorate General for Internal Policies - Policy Department A: Economic and Scientific Policies, European Parliament, Brussels.

Scharpf, F. (1999). Governing in Europe: effective and democratic? Oxford University Press, Oxford.

Schelkle, Waltraud (2005). The political economy of fiscal policy coordination in EMU: from disciplinarian device to insurance arrangement. Journal of Common Market Studies, 43 (2). pp. 371-391.

Schelkle, W. (2012). European Fiscal Union: From Monetary Back Door to Parliamentary Main Entrance, CESifo Forum 1 (special issue on European Fiscal Union)

Schelkle, Waltraud. 2013. “Monetary Integration in Crisis: How Well Do Existing Theories Explain the Predicament of EMU?” Transfer: European Review of Labour and Research 19: 37-48.

Schuknecht (1994). EU Fiscal Rules Issues And Lessons From Political Economy, European Central Bank Working Paper Series No. 421

Schmidt V.A. (2002) The Futures of European Capitalism, Oxford: Oxford University Press

Smith, M. (2013) 'External relations,' in, Cini, M. and Borrogan, N.P-S. (Eds.) European Union Politics: 4th Edition Oxford: Oxford University Press, p.213

Sotiropoulos, D.A. (1993) ‘A Colossus with Feet of Clay: The State in Post- authoritarian Greece’. In Psomiades, H. and Thomadakis, S. (eds) Greece, the New Europe and Changing International Order (New York: Pella)

Spanou, C. (1996) ‘Penelope’s Suitors: Administrative Modernisation and Party Competition in Greece’. West European Politics, Vol. 19, No. 1, pp. 98–125.

Srivangipuram (2012), Monetary Policy in the Eurozone: Evaluating the European Central Bank's interest rate decision and the needs of member states using a Taylor rule, University of California, Berkley, Department of Economics.

Torres, F. (2007). The Long Road to EMU: the Economic and Political Reasoning Behind Maastricht. Working Paper Series, pp. 1-24.

Truger, A. & Will, H. (2012). 'The German 'debt brake' – a shining example for European fiscal policy?'. Institute for International Political Economy Berlin. Working Paper No. 15.

Tsoukalis, L. (1999). Greece: Like Any Other European Country? The Hellenic Observatory discussion paper, LSE, London

Tsoukalis Loukas (2014), The unhappy state of the union, Policy Network

Tuori, K. and Tuori, K. (2014) The Eurozone Crisis: A Constitutional Analysis Cambridge: Cambridge University Press

Tzogopoulos George (2013), The Greek Crisis and the Media – Stereotyping in the international press, Ashgate

Von Hagen, J., & Strauch, R. (1999). Tumbling giant: Germany's experience with the Maastricht fiscal criteria

Wallace, H (1998) "Differentiated Integration", in Dinan, D. (ed.) Encyclopedia of the European Union. Boulder, Lynne Rienner Publishers, 137-

Wagstyl, Stefan (2014) "German Court Refers ECB Bond-buying Programme to European Justice." Financial Times. N.p., 07 Feb. 2014

Weber, C.S., and Forschner, B. (2014) "ECB: Independence at risk?." Intereconomics 49.1: 45-50.

Wildasin, D.E. (2002). 'Fiscal Policy in Post-EMU Europe', EUP, 3, 2, 251-60Van Overtveldt, J. (2011) The End of the Euro: The Uneasy Future of the European Union Aldershot: Ashgate Publishing

Willett, T. D. (1999). A political economy analysis of the Maastricht and stability pact fiscal criteria. [In:] Hutchison, M. M., Hallett, A. H., & Jensen, S. E. H. (Eds.), Fiscal aspects of European monetary integration, pp. 37-68.

Wyplosz Ch., Favero C., Freixas X., Persson T. (2000) One Money, Many Countries: Monitoring the European Central Bank, Centre for Economic Policy Research

Charles Wyplosz (2005) Fiscal Policy: Institutions versus Rules, National Institute Economic Review No. 191

Verhelst, S. (2011) The Reform of European Economic Governance: Towards a Sustainable Monetary Union? Brussels: The Royal Institute for International Relations