View metadata, citation and similar papers at core.ac.uk

brought to you by CORE

Izvorni znanstveni rad
338.23:336.74(4)
338.24(4)
339.738(4)
Received: 4 February 2011

Managing Crisis in the Eurozone

LUKA BRKIĆ*, KRISTIJAN KOTARSKI**

Summary

Euro crisis displayed its full blow in the spring of 2010. Its dynamics revealed deep-seated structural flaws at the core of the EMU. The productive Germany is tied via the euro currency union to countries that have lower productivity rates and inefficient economies. This union has been beneficial to the countries of Southern Europe so far since EMU inception, as it provided them with cheap credit. EMU showcased its problematic institutional design. Compared to mature federations, the institutional design of EMU is incomplete. On the one hand, there is a strong ECB that decides monetary policies for the entire euro area. At the same time, there is a lack of macroeconomic policy coordination for the same area. The budgetary and fiscal policies are set by governments of national states. This is of great concern for the vitality and robustness of the EMU in the context of soft constraints imposed by the Stability and Growth Pact. In the first part, this paper will highlight basic structural problems that led to the current crisis of confidence in the common European currency. The second part intends to discuss the lack of monetary and fiscal policy coordination, while the third part analyzes monetary and fiscal responses to the crisis by the EU institutions and national actors. The fourth part seeks to portray some possibilities for overcoming deep-seated structural imbalances, and questions the likelihood of "gouvernement économique" as a new stage in European integration.

Keywords: euro, financial crisis, monetary policy, fiscal policy, ECB, economic governance

* *Luka Brkić*, Professor at the Faculty of Political Science, teaching *Economic Policy* and *International Political Economy*.

** *Kristijan Kotarski*, PhD candidate, Research Fellow at the Faculty of Political Science, University of Zagreb, in courses *Economic Policy* and *International Political Economy*.

Phases and Origins of the Current Crisis in the Eurozone

The global financial crisis came at Europe in three phases. The first phase was part of the American subprime crisis. Many financial institutions based in Europe were fully complicit in causing the financial turmoil by buying and selling derivatives as well as by acquiring risky assets. The second wave was a uniquely European crisis. European banks had taken massive positions in the Eastern European banking systems. For example, the Czech system was almost entirely foreign-owned.[1] Outstanding loans issued by Austrian banks in Eastern and South-eastern Europe climbed up to €293 billion which could be translated to a liability for each man, woman and child in Austria of €35.075.[2] These banks began lending to Eastern European homebuyers, with mortgages denominated in euros and Swiss francs rather than in the currencies of the countries involved. This allowed banks to reduce interest rates, as the risk of currency fluctuation was pushed over to the borrower. But when the zlotys and forints began to plunge, these monthly mortgage payments began to soar, as did defaults. The industrial production in the Czech Republic in September 2009 fell 13%, while Czech koruna depreciated 7.1% against December 2008.[3] The same happened with Hungarian forint and Polish zloty. Hungarian forint lost almost 20% of its value and industrial production shrank by 9.9%.[4] Poland suffered greatly in terms of exchange rate depreciation as zloty plunged 23.3% at the time when industrial production decline amounted to 7.7%.[5] The European core, led by Germany, refused a European bailout of the borrowers or lenders even though the lenders who created this crisis were based in eurozone countries. Instead, the IMF was called in to solve the problem.[6] This raised the political question in Eastern Europe as to what it meant to be part of the European Union.

The third wave is represented by crisis in sovereign debt in countries that are part of the eurozone, but are not in the core of Europe (PIIGS countries). This wave showed that eurozone governments have failed to place common currency on a solid political and economic foundation. Blaming the speculators garnered some applause, but this analytical approach appears to be too one-sided. Even without deep scrutiny, it is obvious that leaders of the eurozone countries behaved like speculators. Some because they were in too much debt and were cooking the books, and

[1] http://www.stratfor.com/memberships/166322/analysis/20100630_europe_state_banking_system

[2] http://www.spiegel.de/international/europe/0,1518,612608,00.html

[3] http://www.spiegel.de/international/europe/0,1518,614960,00.html

[4] *Ibid.*

[5] *Ibid.*

[6] http://www.stratfor.com/weekly/20100503_global_crisis_legitimacy

others because they turned a blind eye to the malefic dealings for too long. In the spring of 2010, a full-scale crisis erupted in the peripheral country with the shakiest public finances. The Greek crisis made it obvious that the sovereign debt crisis and banking crisis have become intertwined and could feed off each other in the near future. There are four major factors which caused the European banking crisis and preceded the global financial turmoil.[7]

The first factor refers to the euro adoption, which is directly linked to the Europe's local subprime bubble. The cost of borrowing in peripheral European countries (PIIGS) was greatly reduced due, in part, to the implied guarantee that once they joined the eurozone their debt would be as solid as Germany's government debt. Construction along the Valencian coast outpaced the building boom elsewhere across Spain, and accounted for more than 12% of the region's economy in 2008 (more than twice what it had a decade earlier).[8] The industry created so many jobs that in 2006, near the peak of the boom, unemployment in the region, now a staggering 24% (September 2010), dropped below the national average, which is unusual in an area with big seasonal job swings.[9] As a further example, in 2006 there were more than 700,000 new homes built in Spain, more than the total of new homes built in Germany, France and the United Kingdom combined.[10]

Europe's "carry trade" and crisis in Central and Eastern Europe (CEE) can be identified as the second and third factors, which are tightly interrelated and which augmented and accelerated the crisis. Because of this, Swiss francs and euros served as the basis for most of such lending across Europe. Loans in these currencies were then extended as low interest rate mortgages and other consumer and corporate loans in higher interest rate economies in CEE without analyzing the possibility of a sharp devaluation.[11] Troubles of overexposed banks in Italy, Austria, Sweden and Greece have been solved by the IMF and the EU as they ended up bailing out several countries in the region, including Romania, Hungary, Latvia and Serbia. And before the eurozone ever contemplated a Greek or eurozone bailout, it was discuss-

[7] http://www.stratfor.com/memberships/166322/analysis/20100630_europe_state_banking_system

[8] http://online.wsj.com/article/SB10001424052748704476104575439783253733728.html?mod=WSJEUROPE_hpp_LEFTTopStories

[9] *Ibid.*

[10] http://www.stratfor.com/memberships/166322/analysis/20100630_europe_state_banking_system. This was in stark contrast to the conservative approach to development that long held sway here. Until recently, Spain was so frugal and had so little purchasing power that Spaniards referred to "Europe" as the continent beyond the Pyrenees.

[11] In Latvia 90% of total bank loans were held in foreign currency, in Hungary 67%.

ing a potential 150 billion-euro rescue fund for CEE countries at the urging of the Austrian and Italian governments.[12]

The fourth factor, the exposure to toxic assets, culminated in the aftermath of the Lehman Brothers collapse. In October 2009, RGE estimated the total potential eurozone bank losses to amount to €700-900 billion, a large share of which stemmed from U.S. and CEE exposures (Roubini et al., 2010). According to IMF estimates, German banks face total write-downs of US$314-338 billion, of which US$260 billion already recognized by end-2009, and with recapitalization needs of at least US$36 billion among public sector banks (*ibid.*). In addition, German banks hold claims of US$514 billion on the most imperilled peripheral countries (Greece, Spain, Portugal, Ireland), whereas French banks hold claims of US$387 billion on these peripheral countries (and a further US$508 billion on Italy) (*ibid.*).

Lack of Monetary and Fiscal Policy Coordination

Problems facing the European financial sector were merely compounded by deep structural problems at the heart of EMU characterized by the absence of prudent macroeconomic coordination. The capital-poor and inefficient South was not as competitive as the efficient and capital-rich North, and ended up importing capital to make up the difference. Meanwhile, the eurozone had a political logic, but was economically flawed from the start because it attempted to wed 16 fiscal policies with one monetary policy. The need for coordination arises in contexts characterised by interdependencies, due either to the collective goods problem or to externalities. In such contexts, decentralised decision-making in the absence of coordination devices will lead to suboptimal, non-cooperative, Nash equilibria. They result from the existence of collective goods, such as monetary stability or reputation on financial markets and vis-à-vis private agents in general, or from spillovers. Spillovers are to be interpreted as unintended consequences of national macroeconomic policies on other member states economies, and such spillover effects may be positive or negative. In the first category, spillovers may be either positive – the so-called traditional Keynesian spillovers, that result from the multiplier effects of fiscal policies and their 'locomotive effects' through trade – or negative, mostly through induced rise in long term interest rates and fall in the external exchange rate of the common currency when budget deficits increase, as well as the short-term interest rates' hikes that the central bank may want to impose as a retaliatory move when national fiscal authorities appear not to exert enough political will to contain budget deficits (Commission, 2004).

[12] http://www.spiegel.de/international/europe/0,1518,614960,00.html

Because the European monetary union was conceived at a time when monetary stability was widely held to be the single, most desirable objective, and with the aim of minimizing centralisation, that is transferring only monetary powers at the supranational level, while leaving fiscal and tax policies almost intact in the hands of national governments, interdependencies stemming from the use of these instruments were given most attention in the debate over economic policy. The precise rules and institutions that have been chosen for the eurozone in the Maastricht and Amsterdam treaties have been decisively influenced by the inflationary context of the seventies and eighties in the EU, as well as by the then dominant macroeconomic theories (rational expectations macroeconomics) (*ibid.*). But this specific context also predetermined problems associated with the lack of coordination.

Also, from the beginning it was obvious that the eurozone is not an optimal currency area (OCA), as it did not satisfy some basic criteria regarding OCA. At the point when the euro was introduced as a means of payment, the eurozone fulfilled only two criteria regarding the OCA index, trade openness and production diversification. Other two important criteria remained beyond the reach for 12 different economies, namely labour mobility and fiscal transfers. It is contestable whether EU members developed a certain level of homogeneity of preferences in their approach to solving macroeconomic issues.[13] Commonality of destiny is also questionable, since the EU is an association, at most an alliance, and not a transnational state. As an alliance, it is a system of relationships among sovereign states, so they participate in it to the extent that it suits their self-interest or fail to participate when they please. That means that they approach the financial crisis in a national, as opposed to European fashion.[14]

Another serious issue is the stability culture imposed by the Stability and Growth Pact. Although the SGP has undoubtedly made fiscal policies a 'common concern' of the eurozone by focusing attention on fiscal aggregates of member states, it cannot be said to have significantly improved economic policy coordination. At the same time, the SGP turned out to be highly pro-cyclical, because it was mainly focused on fiscal discipline during cyclical downturns, and thus provides wrong incentives since it did not tackle the tendency to run expansionary pro-cyclical policies in good times and does not reduce the political inclination to 'spend the money when it comes in' (Šimović, 2005: 75-88). From the very beginning, the euro was actually far more vulnerable than investors and politicians were willing to admit. Several member states used the façade of a strong global currency primarily to blatantly live beyond their means. But it were precisely France and Germany that broke the fiscal deficit

[13] http://www.econ.ku.dk/okombe/intmonecon/slidesch13part2.pdf

[14] http://www.stratfor.com/weekly/20100510_europe_nationalism_and_shared_fate

rule and denied credibility to the application of the same rule in the time to come. In March 2005, the EU Council relaxed the rules under the pressure of those two countries which were facing high fines for not obeying the SGP (*ibid*.).

The EC said it was to respond to criticisms of insufficient flexibility and to make the pact more enforceable, but in reality it was euthanasia of an already half--dead Treaty. The Bundesbank ruled that the changes would *decisively weaken the rules of sound financial policy.*[15] The ceilings of 3% for budget deficit and 60% for public debt were maintained, but the decision to declare a country in excessive deficit was to be based on a new set of parameters: the behaviour of the cyclically adjusted budget, the level of debt, the duration of the slow growth period and the possibility that the deficit is related to productivity-enhancing procedures (Šonje, 2010). The excessive deficit procedure is not to be enforced when deficit occurs as a result of some unexpected negative shock. Under the new provisions, the previous definition of shock as a result of influence beyond government impact is eliminated in favour of a government's autonomy to determine what really constitutes it.[16] Since joining the eurozone, the 16 euro countries have violated the deficit rule 43 times.[17] The Greeks fudged their statistics by including prostitution, black-market trade and gambling in the calculation of economic output. As a result, GDP rose by a stunning 25 percent in 2006, and the deficit dropped to 2.9 percent.[18] When it comes to better monitoring the member states' compliance with SGP rules, an important role is to be attributed to Eurostat. A regulation reinforcing the audit powers of Eurostat has recently been agreed by the Council of Ministers on 26th of July 2010.[19] But this course of action, which envisages more frequent and comprehensive regular statistical visits in the context of the standard Excessive Deficit Procedure (EDP), is under threat from undermining its efficiency unless the financial derivatives market is to be supervised. Credit lines disguised as a swap did not show up in the Greek debt

[15] http://www.spiegel.de/international/europe/0,1518,682432-4,00.html

[16] The behaviour of the cyclically adjusted budget is an arbitrary decision because it depends on the econometric approach and model assumptions. The excessive deficit procedure is not to be activated if there is a big difference between real and potential GDP, which is also subject to the same criticism as the structurally adjusted deficit. By that point, the pact had clearly been weakened because revenues were antedated, expenditures were concealed, and debts were hidden.

[17] http://www.spiegel.de/international/europe/0,1518,682432-4,00.html

[18] *Ibid.*

[19] But further steps, including further strengthening of the professional independence of the European Statistical System as well as Eurostat's audit powers, should be considered. Sanctions for repeated statistical problems, such as lack of validation of data by Eurostat, should also be considered. The binding nature of the "European statistics code of practice" should be reinforced, and some of the minimum standards should be enshrined in a legal act. http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/117236.pdf

statistics, so the conclusion that the Maastricht rules can be circumvented quite legally through swaps is ineluctable.[20] This means that fiscal policy coordination has to go hand in hand with sophisticated oversight of financial markets.

With regard to fiscal policies, the 'one-size-fits-all' character of the rules may also prove harmful in a number of contexts, as illustrated by the case of Ireland in 2001, formally in line with the deficit and debt requirements of the SGP, but in practice having too expansionary a fiscal stance, given the high growth, high inflation situation of the country at the time (Commission, 2004). Although GDP per capita in Ireland and Greece rose from 1999 to 2007 by an astonishing 59.6% and 39.3% respectively (compared to Germany's 12.4%), this was only due to a credit bubble which signifies divergence instead of convergence among the eurozone countries (Ivčić and Cerovac, 2010). Wages grew faster than productivity, thus unit labor costs and inflation rose, while real exchange rates based on such unit labor costs appreciated sharply. These structural problems and flawed conception of economic policy had only been exacerbated by challenges endemic to Club Med countries such as corruption, non-transparent banking systems, large social welfare outlays, overreliance on the real estate and construction industries for recent economic growth and lack of manufacturing capacity.[21]

Crisis Management in the EU

The fact that the EU is based on the exclusive power of the member states' national authorities and that these have shown to be extremely reluctant to give more power to the Union, results in the fact that dealing with systemic crises becomes almost impossible, unless there is a large degree of coordination among them, which has not been the case until today. EU's response to the crisis so far can be characterized as discordant, with essentially every country looking to fend for itself ("capital nationalism"). With each banking system tightly integrated into the political economy of each EU member state, an EU-wide solution to Europe's banking and sovereign debt problems is far from certain. An approach to banking problems was largely conducted on an *ad hoc* basis, as each government has taken extra care to specifically tailor its financial assistance packages to support the most and upset the fewest constituents. The European Commission has only very limited latitude when it comes to

[20] In the Greek case, the US bankers devised a special kind of swap with fictional exchange rates. That enabled Greece to receive a far higher sum than the actual euro market value of 10 billion dollars or yen. In that way, Goldman Sachs secretly arranged an additional credit of up to $1 billion for the Greeks. http://www.spiegel.de/international/europe/0,1518,676634,00.html

[21] From 2003 to 2007, the Irish banking system imported funds equivalent to over 50 percent of GDP to fund a runaway property and construction bubble. http://www.spiegel.de/international/europe/0,1518,719723,00.html

combating the crisis. When fair competition within the EU market is not the issue, the Commission simply lacks the necessary tools to deal with the crisis. As a result, Europe today is only as strong as the 27 heads of government in the EU allow it to be. But views on many issues differ widely in Berlin, London, Paris, Rome, Vienna or Bratislava, especially after the immediacy of the crisis is perceived to have passed. The EU member states are notorious for ignoring the Commission's attempts to reprimand them, and they tend to band together against the Commission, which has no public to answer to and no real enforcement powers against a sovereign nation. It is also very rare that one member state will vote to sanction another, for fear that it will have to deal with repercussions when it is in the hot seat itself.

When analyzing the financial crisis management in the EU, one must observe that the wrong approach has been rooted in the financial supervisory failure, monetary policy failure and fiscal policy coordination failure. It has enabled the uncontrolled leveraging of financial institutions, bloated public sector and the break-up of the ECB's independence during the crisis. The European banking and sovereign debt crisis can be divided into the period preceding the introduction of the EFSF (European Financial Stability Fund) and the period afterwards. The following pages shed light on Germany's role in managing the crisis, since it is the biggest economy in the eurozone and almost explicitly shaped the eurozone's responses in this turbulent period.

The overall approach to crisis preceding the Europe-wide bailout in May 2010 can be labelled as non-coherent; it showed the strong prevalence of national political concerns in tackling systemic challenges. While the Greek debt problem was expanding into a risk to the global financial system, the coalition government in Germany remained stubbornly focused on another problem: the state elections in North-Rhine Westphalia. Angela Merkel, German chancellor, stirred up resentment against the Greeks by resisting to approve an early financial bailout for Athens, and sent completely different signals than the most important member of her cabinet, Finance Minister Wolfgang Schäuble. Namely, he was tasked with reassuring the markets, while Merkel was trying to reassure the German public that she was not being soft on the Greeks. On the other hand, the German Finance Minister wanted to establish a European Monetary Fund while the Chancellor was against it.

In the course of taming the sovereign debt and the European banking crisis in the spring of 2010, two basic reactions emerged. Their sheer size and broad scope cannot overshadow their partiality and lack of coherence. The first of them was to set-up the eurozone-wide €750 billion bailout plus a €110 billion rescue package for Greece (see Table 1 on the next page).[22]

[22] http://www.spiegel.de/international/europe/0,1518,694784,00.html

Table 1. €750 billion bailout

EUROS	SOURCE	DESCRIPTION	AVAILABILITY
60 billion	EU Balance of Payments Facility	Originally a fund to help Central/Eastern Europe states, expanded in volume and purpose to now also apply to the eurozone	Immediate, the fund is already set up
Up to 150 billion	IMF	IMF resources that can be tapped to help eurozone states in need, with conditions to be set on an individual basis	Immediate, available from the IMF
Up to 440 billion	Individual EU member states participating	New facility that will issue debt guaranteed by contributing states so that it can purchase the debt of the troubled eurozone economies	Guarantees must be officially pledged by contributing states' governments first
To be determined	European Central Bank (ECB) – Securities Markets Program	Reintroduced unlimited liquidity for three- and six-month durations in addition to directly purchasing government debt	Already operational

Source: STRATFOR

The European leaders and the IMF made €750 billion available to help the eurozone states teetering on the verge of an abyss, in case they found themselves in a financial emergency when market-imposed interest rates on government bonds spiralled out of control. They have not been bothered by the fact that the EU treaties do not contain provisions for such aid. Indeed, they had already ignored the no-bailout clause in the Maastricht Treaty when they agreed to rescue Greece. In February 2009, German Finance Minister Peer Steinbrück openly stated that if one of the euro countries encountered financial difficulties, *the community will have to come to its aid*.[23] There is a de facto bail-out agreement among the euro countries, says Hamburg economist Dirk Meyer, noting that the no-bailout clause is *not workable*.[24]

[23] http://www.spiegel.de/international/europe/0,1518,682432,00.html

[24] *Ibid.*

The second response came in the form of ECB-provided unlimited volume of loans to any bank that could offer qualifying collateral, while national governments offered their own guarantees on the newly-issued debt. The independence of the European Central Bank, once held a taboo in order to keep the value of money stable, has been sacrificed in order to restore liquidity to the banking sector and to ease pressure on the price of PIIGS government bonds. Essentially it was conducted in five major steps:

1. Governments incur debt: The competition between investors bids the bond prices up, in turn lowering the bond's yield.
2. Private banks buy government debt: Since October 2008, the ECB has offered to fully accommodate the banks' demand for liquidity, provided they pledged eligible collateral such as government bonds, and has offered to lend the liquidity for periods up to three, six or even 12 months.
3. Private banks use government debt as collateral: The ECB decided to lower the threshold at which it would accept government debt (from A- to BBB-) – giving all countries, but especially those in crisis like Greece and Portugal, a breather. Further credit downgrades would make its bonds ineligible as collateral at the ECB, but even barring further downgrades, the lowered collateral threshold is set to expire on Jan. 1, 2011, which would mean that as it stands, Greek bonds would be ineligible unless they get back up to A- by then.[25]
4. Banks purchase more debt: European banks have jumped at this opportunity to refinance their assets with the ECB at the very attractive fixed rate of 1 percent. The one-year liquidity operations have been very popular – in 2009, banks took out 442 billion euro in June, 75 billion euro in September and 96 billion euro in December.[26]
5. Government debt yields kept low: This "loans-backed-by-bonds-to-purchase-loans-backed-by-bonds" cycle keeps the yields low due to continued demand to use them as collateral with the ECB.

By buying up the debt of Club Med countries, the ECB kept the price of bonds artificially high. French banks benefited in particular from this policy because it enabled them to sell their Greek bonds to the ECB, an inexpensive way of cleaning up their balance sheets.[27] The continuation of this policy effectively poses a serious risk of the ECB becoming a so-called "bad bank" or a bank that buys up toxic assets

[25] http://www.stratfor.com/analysis/20100224_eu_extended_liquidity_support_ecb

[26] *Ibid.*

[27] France's banks and insurance companies had a total of about €80 billion in Greek government on their books. ECB President Jean-Claude Trichet caved in to massive pressure from French

as a means of helping out other institutions. The central bank's capital, currently about €70 billion, most of which is invested in the national central banks, would be severely affected in the case of default.[28] Economists who have always believed that a few days of robust ECB market intervention would be enough to reassure market players and bring yields back to a normal level were mistaken. Without the immediate installation of any sovereign default mechanism such as some sort of European Monetary Fund, the ECB would have to bear the burden. It would run the risk of degenerating towards the "bad bank" of the euro area if timid investors offloaded sovereign bonds with uncertain repayment values on the ECB's balance sheet.[29]

The next step to combat the magnitude of the financial crisis in Europe with a view to bolstering the ECB's actions and the credibility of the newly-established European bailout package was seen in the austerity measures. EU governments have undergone rounds of belt-tightening measures, including cutting social services and raising retirement ages. Even Germany, Europe's strongest economy, pushed through its own far-reaching savings package. Announced austerity measures in Spain climbed up to €65 billion, in Italy €24 billion, Greece €35 billion, Ireland €15 billion, and Germany €80 billion.[30] To resolve the bloated budget deficits of the Club Med countries and as an assurance that it would not have to bail out every southern country like Greece, Berlin has demanded that these countries implement severe budget cuts and that southern European countries begin implementing the German-style labor market and public sector reform. This kind of direction establishes some sort of credibility for the EFSF, but it denies the potential risks of such a conception.

Prolonged bickering over the Greek bailout led to market uncertainty that spread to the rest of the eurozone, forcing Germany to eventually underwrite the 750 billion euro bailout for the eurozone as a whole.[31] Near the end of the Greek sovereign debt crisis, Germany realized that it needed to develop a mechanism to enforce its will without acquiring the approval of other EU states if further eurozone countries

President Nicolas Sarkozy (http://www.spiegel.de/international/europe/0,1518,697680,00.html).

[28] The member states could then inject new capital into the ECB, which is problematic regarding the level of their indebtedness. The other two solutions are recapitalization by issuing bonds or firing up the printing press. The German Finance Minister will feel the effects of this policy as Bundesbank regularly transfers its profits to the federal government at the end of each year. http://www.spiegel.de/international/europe/0,1518,697680,00.html

[29] http://www.europarl.europa.eu/document/activities/cont/201009/20100908ATT81662/20100908ATT81662EN.pdf

[30] http://web.stratfor.com/images/charts/Europe_austerity_measures_800.jpg

[31] http://www.spiegel.de/international/europe/0,1518,697098,00.html

were to be bailed out. Not only was it obvious that Germany was sitting in the same boat with other member states breaking the SGP rules, but it also wanted to obtain a mechanism to help their own banks under threat of bearing the costs of unorderly proclaimed bankruptcies. Its solution was the EFSF. The EFSF is not an EU institution like the European Commission or any other bureau.[32] Rather, it is a limited liability corporation registered in Luxembourg. Specifically, it is a Luxembourger bank. This arrangement allows the Germans to evade the pre-existing EU Treaty law. The EFSF can therefore bail out member states, indirectly regulate the banking sector, set up a "bad bank" to rehabilitate European financial institutions, or favour one member or penalize another without a unanimous vote, which clearly represents actions explicitly or implicitly barred by the EU Treaty law. The EFSF requires no act by the Commission, no additional approval from 27 different parliaments and no unanimous vote among the various EU heads of government to forward its loans.[33]

The eurozone has thus far been exceedingly economically beneficial to Germany. Berlin's 151 billion euro contribution to the two bailout funds pales in comparison to the overall boost in exports that Berlin has received since forging the eurozone. Furthermore, Germany's banks are looking at approximately 520 billion euros worth of direct exposure to various forms of debt in Greece, Portugal, Spain and Italy.[34] The crisis has spurred member states toward economic reform for different reasons. The Club Med countries will do anything to get financial support, while Germany and Northern European economies will give less priority to sovereignty of legitimate concerns that a Greek collapse will harm their own economies. This kind of crisis management shows an underlying nationalist calculus, and not an integrationist "European" one.

After a long and protracted debate on the need of imposing automatic sanctions against fiscally irresponsible EU governments, which was essentially Germany's rationale, German Chancellor Merkel and French President Nicolas Sarkozy came to a compromise on reforms to European fiscal rules. On 19th of October in Dauville, Germany accepted the French demand that a permanent stability fund be set up to prevent future existential crises in the eurozone.[35] This amounts *de facto* to the inception of the European Monetary Fund under Germany's control, which outraged other member states which were held aside. The French side accepted German demands for stricter enforcement mechanisms regarding fiscal policy rules and for the reforms to be written into the EU Constitution via a Treaty adjustment.

[32] http://www.stratfor.com/analysis/20101104_german_designs_europes_economic_future

[33] *Ibid.*

[34] http://www.stratfor.com/analysis/20100514_germany_creating_economic_governance

[35] http://www.spiegel.de/international/europe/0,1518,725835,00.html

EU member states would still retain the ability to vote whether to give the European Commission the authority to first launch an excessive budget deficit procedure against the offending eurozone member state, a concession France and a number of Mediterranean countries wanted in exchange for agreeing to reform the Treaty along the proposed lines.[36] The process of trying to impose new sanctions could be affected by the "reverse majority" rule.[37]

The lack of coherence in the overall approach to financial crisis management can be seen in the stance of the German Chancellor, who displayed an elastic loyalty to principles when the European common currency experienced turbulence. She initially spent weeks postponing the idea of aiding Greece. In the end, Germany shouldered the largest share of the bailout. As the euro crisis became increasingly dangerous, and additional countries ran into difficulties, she resisted a bailout package for the entire eurozone. In the end, Germany once again had to pay the largest contribution. Her latest U-turn when it comes to automatic sanctions certainly does nothing to instil confidence in the embattled euro.[38] It seems as though a blend of ideological prejudices, financial interests and dogmas cloaked as national interests, political calculation and the lack of common historical experience in financial crisis management, produced a wrong set of answers. In fact, the only idea worth of praise was that bondholders and investors would be expected to shoulder the costs of bailing out EU member states in the future, as some member states such as Greece and Ireland are insolvent.[39] E.g. Professor Morgan Kelly of University College Dublin estimates that the cost of the Irish financial sector bailout amounts to €70 billion, which means that under this scenario every single eurocent paid in income tax in the next seven years is earmarked for that purpose.[40]

The instrumentalisation of the euro as a common currency shows the extent to which banks still hold the power. The ECB has never given way to politicians when they ask it to lower rates or to privilege growth over the fight against inflation, but this time it has caved in to pressure from the banks. This is only the first of many

[36] http://www.stratfor.com/analysis/20101019_remaking_eurozone_german_image

[37] In practice this would mean that any recommendations of the European Commission to impose sanctions on a member state could be contested if rejected by a qualified majority of finance ministers. The sanctions do become quasi-automatic if EU states authorize the European Commission to go forward with an excessive debt procedure and the offending country does not remedy the excessive deficit within six months. In that case, only a qualified majority vote of member states or compliance would be able to halt the clearly defined, automatic sanctions, so Berlin still retained an element of what it wanted.

[38] http://www.spiegel.de/international/europe/0,1518,725079,00.html

[39] http://www.spiegel.de/international/europe/0,1518,705959-2,00.html

[40] http://www.spiegel.de/wirtschaft/soziales/0,1518,728699,00.html

misconceptions affecting the eurozone. The second and even more dangerous one is to impose drastic austerity measures in order to cut public debt and fiscal deficit in a deflationary context. In sum, both of the following statements are true: countercyclical spending worsens government finances, and austerity compounds an already miserable unemployment situation. But cutting spending in the middle of a recession is no solution, especially when market participants conflate stimulus spending with bailouts of the financial system. Such a strategy may sound sensible, but it relies on the same fallacy of composition that brought on the banking crisis. Economist Michel Aglietta said: *To impose crushing austerity measures on Greece and pretend that it will pull through by itself in a context of internal recession, likely deflation and the feeblest European growth rates, is to set a time bomb that could cost Europe dearly* (Belkaïd, 2010).

The final misconception manifests itself in the sense that new regulatory bodies with brand new names but no teeth replace the old ones in the hope that the gap between regulators and financial markets could be bridged.[41] Since the euro crisis erupted, this sort of palliative measure has been introduced, e.g. the European Systemic Risk Board.[42] It is also worthwhile to mention other three important bodies which started to operate on 1st of January 2011: European Banking Authority, European Insurance and Occupational Pensions Authority, and European Securities and Financial Market Authority. Still, none of the statesmen and EU citizens can rest while the key problem remains unsolved. Last June, parliamentarians of various political stripes asked for help as they published a warning that *the asymmetry between the power of this lobbying activity and the lack of counter-expertise poses a danger to democracy*.[43] They called on NGOs, trade unions, academic researchers and think-tanks to get together to counter the financial lobbyists.[44] The urge to act is severe, but all the while it is obvious that Europe has no long-term and broad vision

[41] http://www.ripe.hanfa.hr/edukacija/tekstovi/nova-struktura-za-nadzor-financijskog-sektora-eu-a

[42] ESRB is an independent EU body responsible for the macro-prudential oversight of the financial system within the Union. Its seat is in Frankfurt am Main. Its secretariat is ensured by the ECB. The ESRB contributes to the prevention or mitigation of systemic risks to financial stability in the Union that arise from developments within the financial system. It takes into account macroeconomic developments, so as to avoid periods of widespread financial distress. http://www.financialregulationforum.com/wpmember/european-systemic-risk-board-5233

[43] http://www.spiegel.de/wirtschaft/soziales/0,1518,708241,00.html

[44] Expert Group on Banking, which was recently formed to advise the European Commission's directorate general in charge of EU policy related to the financial services sector, faced the same obstacle when the group held its first meeting, on June 14. Only four of its 40 members did not have the background from the world of banking and financial markets. http://www.spiegel.de/wirtschaft/soziales/0,1518,708241,00.html

when it comes to solving the financial crisis and rebalancing its economies. Therefore, better economic governance, which entails fiscal policy coordination together with financial market regulation and supervision, is desperately needed in order to build a stronger EU. This will be discussed in the following chapter.

Short History of the Attempts to Create Gouvernement Economique

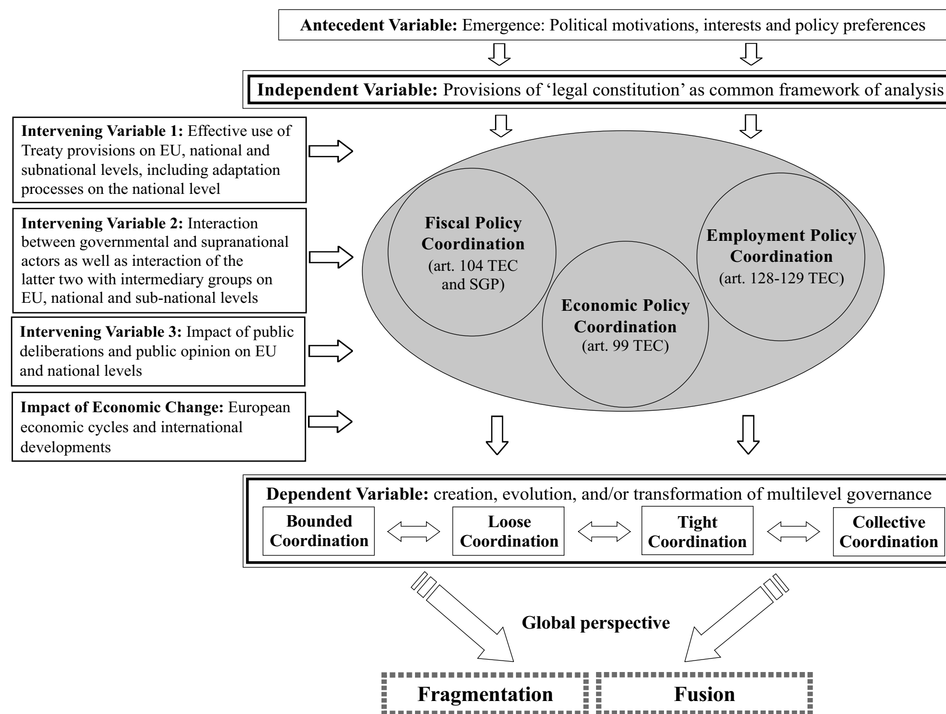
At the 1969 summit in The Hague, the heads of states and government decided to explore a possible path to EMU. Pierre Werner, Prime Minister and Finance Minister of Luxembourg, drafted the blueprint together with a group of experts. The plan encompassed three stages to reach EMU by 1980. On the institutional side, it envisioned setting up two supranational bodies: a 'Community System for the Central Banks' and a 'Centre of Decisions for Economic Policy' (Cini, 2007). The former would pursue monetary policies, and the latter would coordinate macroeconomic policies. Nevertheless, the combination of the first oil shock impact and the crumbling of the Bretton Woods arrangement postponed those efforts to a later date. Ten years later, a new attempt at creating EMU was pushed forward by launching the European Monetary System. Germany insisted that a further monetary integration could occur only after other participating countries reduced their inflation rates to German levels and pledged to create a European institution on technocratic and anti-inflationary rules: a politically independent European central bank to replace the Bundesbank and strict rules governing national fiscal policies. The other major participants in the EMS, France and Italy, resisted these demands until the early 1990s, since implementing them would have required a politically painful tightening of monetary and fiscal policies to reduce inflation. French and Italian decision-makers preferred that the EMS evolve in a more politicized direction that would require participating governments to set common economic policy priorities, which would provide a platform from which the French and the Italians could press Germany to soften its monetary policy and influence aggregate demand (Walsh, 2001: 59-80).

Preferences regarding European monetary institutions did not converge during the 1990s. The French and the Italians continued to propose the centralization of economic policy authority in political bodies and giving greater weight to employment and the coordination of countercyclical economic policies, whereas German preferences leaned in the opposite direction, toward buttressing the independence of the European Central Bank and limiting fiscal policy flexibility. German negotiators succeeded in pushing through the Stability Pact's requirements for the management of the single currency against the opposition of most other states, although they did concede that states could temporarily run excessive deficits under certain circumstances and that the EcoFin would have a modest degree of leeway in interpreting national fiscal policies. The German government also succeeded in curtail-

ing the long-standing French desire for a political counterweight to the European Central Bank by insisting that the Euro Council remain an informal consultative body that would not question the central bank's power to make decisions regarding monetary policy (Walsh, 2001: 59-80).

Any system of economic management has to balance competing aims and proposals for reform of the ECB and the SGP. Even so, a cursory look at how policy is being coordinated in the EU shows not only that there is much of it going on, but also that it is being done through an eclectic range of approaches. The underlying question, however, is whether current arrangements provide a policy framework that is robust enough for what EMU will become five, ten or twenty years hence. There are four different scenarios when it comes to coordinating economic governance (see Figure 1).

Figure 1. Possible scenarios for economic governance in the EU



Source: Commission (2004, August)

Bounded coordination describes a scenario in which the rules for policy coordination are becoming dead letters, at best symbolically followed and routinely ignored when formulating national responses to economic policy challenges. This scenario amounts to a status-quo ex-ante minus (Commission, 2004).

Loose coordination means that participants follow largely opportunistic strategies and that they comply when the benefits are obvious and the costs negligible. With regard to the question of scope for policy coordination, we would find only little changes.

Tight coordination can be seen as an upgraded status-quo ex-ante scenario, where the EU-level institutions, procedures and goals of economic governance enjoy strong support, where participants are ready to accept costs for reaching common goals, and where political actors are adhering to and extending 'the spirit of policy coordination' (*ibid*.).

Finally, one can envisage a transformation scenario, in which member states and EU institutions alike are increasingly being socialised into *collective coordination*. This is understood as a governing arrangement, which builds up mutual trust through deliberative problem-solving rather than instrumental bargaining and does only rarely need to use the provisions for qualified majority voting (*ibid*.). Collective coordination might also be viewed as the fulfilment of demands calling for the establishment of a "gouvernement économique", although the actors of this evolving "core network" would encompass not only national governmental actors, but also European institutions such as the Commission and the ECB, and European social partners. In the wake of the crisis, Herman van Rompuy told the press: *We consider that the European Council should become the economic government of the EU and we propose to increase its role in economic surveillance and the definition of the EU's growth strategy*.[45]

At the moment, the fear of a financial Armageddon has disappeared and crisis management rules have not been institutionalized. This means that Europe is currently heading towards a loose coordination which means a fragmentation scenario in the future.

Conclusion

The fact that the European Union is based on the exclusive power of the member states' national authorities and that these have shown to be extremely reluctant to give more power to the EU, results in the fact that dealing with systemic crises becomes almost impossible today. The recent experience casts into question whether

[45] http://www.telegraph.co.uk/news/worldnews/europe/eu/7521434/EU-draws-up-plans-for-single-economic-government-to-prevent-crisis.html

any economic recovery can occur as long as the financial markets are able to bet massively against the European integration project in the absence of coherence and congruence among key political decision-makers. Adding to the standard line of conflict between supranational authorities and member states, we have to point to a second line of conflict, which is almost impossible to solve without further integration steps, and that is the conflict between nation states and financial markets. This effectively underlines the need for EU's integrated measures for macro-economic stimulation such as integrated tax structure, a central bank dedicated to economic prosperity, and a reduction of the financial sector. Cutting down the financial sector can be achieved by regulation, by taxation and by restructuring the debts of the Mediterranean states (Galbraith, 2010). A more ambitious reflection would try to explore the possibilities of developing an original brand of highly decentralised federalism in which the central budget would remain relatively small, but in which an appropriate mix of rules and financial incentives, in the European budget, would be set up in order to induce national governments to undertake actions that are collectively considered to be in the common interest. The past decade has been a lucky time in Europe, but the ongoing downturn will test the eurozone cohesion. Barry Eichengreen claims: *A crisis is a terrible thing to waste*.[46] Europe must choose. *The choice is between the disastrous radicalism of budget cuts and a constructive radicalism of full employment. Or between a disastrous radicalism of bank bailouts and a constructive radicalism of social development* (Galbraith, 2010).

REFERENCES

Begg, I., 2003: Hard and soft economic policy coordination under EMU: problems, paradoxes and prospects, *Center for European Studies Working Paper Series #103*.

Belkaïd, A., 2010: The high price of the euro, *Le Monde diplomatique*, June.

Bilas, V., 2005: Teorija optimalnog valutnog područja: Euro i Europska monetarna unija, *Zbornik Ekonomskog fakulteta u Zagrebu* (3): 39-53.

Cini, M., 2007: *European Union Politics*, Oxford University Press, Oxford.

Commission, 2004: *EU Governance by self co-ordination? Towards a collective 'gouvernement économique'*, Directorate-General for Research, Directorate L – Science, economy and society, August.

Galbraith, J. K., 2010: The wolf pack stalks Europe, *Le Monde diplomatique*, June.

Ivičić, L., Cerovac, S., 2010: I plaće su krive, *Banka*, September.

[46] http://www.roubini.com/briefings/47577.php

Roubini, N., Menegatti, C., Ziemba, R., 2010: *Global Economic Outlook Overview July 2010*, Roubini Global Economics.

Šimović, H., 2005: Fiskalna politika u Europskoj uniji i Pakt o stabilnosti i rastu, *Zbornik Ekonomskog fakulteta u Zagrebu* (3): 75-88.

Šonje, V., 2010: Eurozona: istina, pogreške i zablude, *Banka*, June.

Walsh, J. I., 2001: National Preferences and International Institutions: Evidence from European Monetary Integration, *International Studies Quarterly* (45): 59-80.

http://www.europarl.europa.eu/document/activities/cont/201009/20100908ATT81662/20100908ATT81662EN.pdf [Accessed 06/11/10]

http://www.roubini.com/briefings/47577.php [Accessed 12/11/10]

http://www.spiegel.de/international/europe/0,1518,682432-4,00.html [Accessed 05/09/10]

http://www.spiegel.de/international/europe/0,1518,694784,00.html [Accessed 14/05/10]

http://www.spiegel.de/international/europe/0,1518,682432,00.html [Accessed 05/09/10]

http://www.spiegel.de/international/europe/0,1518,697680,00.html [Accessed 01/06/10]

http://www.spiegel.de/international/europe/0,1518,725079,00.html [Accessed 25/10/10]

http://www.spiegel.de/international/europe/0,1518,705959-2,00.html [Accessed 13/07/10]

http://www.spiegel.de/wirtschaft/soziales/0,1518,728699,00.html [Accessed 12/11/10]

http://www.spiegel.de/international/europe/0,1518,719723,00.html [Accessed 27/09/10]

http://www.spiegel.de/international/europe/0,1518,697098,00.html [Accessed 27/05/10]

http://www.spiegel.de/international/europe/0,1518,725835,00.html [Accessed 29/10/10]

http://www.spiegel.de/international/europe/0,1518,612608,00.html [Accessed 10/10/10]

http://www.spiegel.de/international/europe/0,1518,614960,00.html [Accessed 10/10/10]

http://www.spiegel.de/wirtschaft/soziales/0,1518,708241,00.html [Accessed 20/12/10]

http://www.spiegel.de/international/europe/0,1518,676634,00.html [Accessed 20/12/10]

http://web.stratfor.com/images/charts/Europe_austerity_measures_800.jpg [Accessed 30/10/10]

http://www.stratfor.com/analysis/20101104_german_designs_europes_economic_future [Accessed 05/11/10]

http://www.stratfor.com/analysis/20100514_germany_creating_economic_governance [Accessed 16/05/10]

http://www.stratfor.com/memberships/166322/analysis/20100630_europe_state_banking_system [Accessed 03/06/10]

http://www.stratfor.com/weekly/20100510_europe_nationalism_and_shared_fate [Accessed 17/05/10]

http://www.stratfor.com/analysis/20101019_remaking_eurozone_german_image [Accessed 23/10/10]

http://www.stratfor.com/weekly/20100503_global_crisis_legitimacy [Accessed 16/06/10]

http://www.stratfor.com/analysis/20100224_eu_extended_liquidity_support_ecb [Accessed 26/02/10]

http://www.econ.ku.dk/okombe/intmonecon/slidesch13part2.pdf [Accessed 10/11/10]

http://online.wsj.com/article/SB10001424052748704476104575439783253733728.html?mod=WSJEUROPE_hpp_LEFTTopStories [Accessed 30/09/10]

http://www.telegraph.co.uk/news/worldnews/europe/eu/7521434/EU-draws-up-plans-for-single-economic-government-to-prevent-crisis.html [Accessed 20/09/10]

http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/117236.pdf [Accessed 03/01/11]

http://www.ripe.hanfa.hr/edukacija/tekstovi/nova-struktura-za-nadzor-financijskog-sektora-eu-a/ [Accessed 03/01/11]

http://www.financialregulationforum.com/wpmember/european-systemic-risk-board-5233 [Accessed 03/01/11]

Mailing Address: **Luka Brkić**, Faculty of Political Science, Lepušićeva 6, HR 10000 Zagreb. *E-mail*: luka.brkic@zg.t-com.hr

Mailing Address: **Kristijan Kotarski**, Faculty of Political Science, Lepušićeva 6, HR 10000 Zagreb. *E-mail*: kristijan.kotarski@fpzg.hr