Fiscal Federalism and the Political Economy of Eurozone Integration

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FISCAL FEDERALISM AND THE POLITICAL ECONOMY OF EUROZONE INTEGRATION

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Abstract

The purpose of this thesis is to identify the political, institutional and economic obstacles to achieving economic integration and stability in the euro area while finding a solution to those obstacles by examining the economics and political dynamics of the currency union. The benchmarks of the Maastricht Treaty and the Stability and Growth Pact encouraged cosmetic reforms that did little to alter the structural problems of the Eurozone's economic periphery. Therefore, the best political and economic solution to the problem of integration is to allow for fiscal federalism within the union whereby Member States take full ownership of their economic policies. Although decentralizing fiscal policy is an essential part of fostering integration, harmonizing banking regulation throughout the Eurozone is also necessary course of action.

The guarantee of emergency funds for Eurozone states at the precipice of default will only breed a moral hazard for more rule-breaking. The conditionality of tough austerity measures of the emergency programs also breeds popular animosity against the euro and outsources the moral and political responsibility of unpopular structural reform to forces outside of the country. Member States should allow heavily indebted states to default and allow banks that made investments in those countries' debts to incur losses. Through enforcement of the no-bailout clauses of Eurozone agreements, domestic

political actors will be unable to issue more debt and thus have the political cover to impose the necessary structural reforms to improve the economic sustainability of their respective countries. Since an exit from the currency union would aggravate the debt problems of a peripheral Member State, the rest of the euro area is unlikely to suffer the loss of membership by refusing to transfer funds to its insolvent members.

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List of Acronyms

BEPG	Broad Economic Policy Guidelines
EBA	European Banking Authority
ECB	European Central Bank
EFSF	European Financial Stability Facility
EFSM	European Financial Stability Mechanism
EMF	European Monetary Fund
EMS	European Monetary System
EMU	European Monetary Union
EPL	Employment Protection Legislation
ERM	Exchange Rate Mechanism
ESM	European Stabilization Mechanism
ESRB	European Systemic Risk Board
EU	European Union
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
IMF	International Monetary Fund
LCU	Local Currency Unit
OCA	Optimum Currency Area
OECD	Organization for Economic Cooperation and Development
OMC	Open Method of Coordination
PIGS	Portugal, Ireland, Greece, Spain
SE-4	Southern European Member States (Italy, Spain, Greece, and Portugal)
SGP	Stability and Growth Pact
TFEU	Treaty on the Functioning of the European Union
ULC	Unit Labor Costs

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Introduction:

European Monetary Union (EMU) symbolized another step towards European integration and away from the political and economic divergences that plagued the continent for many centuries. Although political motivations were responsible for making the framework a reality, potential economic benefits contributed to the desire for monetary union as well. The institutional weaknesses of the arrangement were not apparent at the beginning, but revealed themselves in the aftermath of the first global economic crisis since the establishment of the euro. The economic fissures afflicting the union are a consequence of distorted national economic policy structures that compromised the fiscal positions of the Eurozone periphery. Their difficulties are also a result of the credibility gap that was endemic in the treaties of the monetary union. In order to maintain the economic integrity of the Eurozone, several countries will have to undergo significant changes in their deeply imbedded socioeconomic structures or suffer the consequences of crippling debt, high unemployment, and stagnant economic growth.

To ensure the integration and economic health of the common currency, the project of monetary union in Europe evolved through several stages. In 1991, the European Community agreed to undergo three steps towards the formation of economic integration. The first was completing an internal market through the free movement of labor, goods, services and capital. The second was the Maastricht criteria for convergence, and the final stage was European Monetary Union (EMU), which was supplemented by the Stability and Growth Pact (SGP) (Barrell, Ray 1992).

During the Maastricht and the SGP periods, Member States seemed to have made progress toward achieving fiscal stability and sustainability. In recent years, however, some of those countries have backslidden into precarious economic circumstances and have compromised the viability of the union. That development led observers to examine some of the deficiencies of the economic rules and guidelines of the Eurozone. The purpose of this thesis is to examine the political, institutional and economic obstacles to achieving economic integration and stability in the euro area while finding some solution to those obstacles by analyzing the economics and political dynamics of EMU.

Although the purpose for establishing EMU was mainly political, the creation of rules to maintain the economic integrity of the union put pressure on the traditional monetary and fiscal models of some of the Member States. On the surface, the Maastricht Treaty and the SGP produced a degree of interstate economic convergence that Europe had never seen. Nevertheless, the causal link between those agreements and fiscal contraction in the euro area remains a source of debate. There is little doubt that the agreements were unable to prevent the current crisis and are no longer regarded as blueprints for resolving it.

The four entry requirements of the Maastricht Treaty (Section 109J) were that Member States needed to have converging inflation rates that matched the rates of the three members with the lowest rates, nominal exchange rates had to remain stable, nominal exchange rates had to converge, and deficits could not exceed 3% of GDP. The final requirement, however, allowed for significant discretion. "Article 104c(a) states that a deficit might not be considered excessive if it has 'declined substantially and continuously reached a level that comes close to the reference value" (Eichengreen, Barry

J. 1995). That ambiguous caveat allowed for states with traditionally high deficits to finagle their way into the monetary union.

In order to enforce compliance with economic benchmarks, the SGP consisted of a preventative and a corrective measure that Member States were beholden to. The preventative arm of the Pact took the form of multilateral budgetary surveillance, while the corrective arm allowed the Council to instruct Member States to meet the 3% of GDP deficit threshold or incur financial sanctions instead (Heipertz, Martin and Verdun 115). Nevertheless, the council never imposed any corrective measures because the more influential members of the Eurozone manipulated the process to avoid sanctions they would have incurred.

This thesis will go on to argue that the best possible sanction for fiscal irresponsibility exists within the forces of markets—not institutions. If governments are irresponsible or enact policies that are economically unsustainable, market forces respond by divesting from their private and public sectors. The painful market-based consequences of bad economic policy deliver more appropriate and efficient signals for domestic political actors and voters that large multinational bureaucratic institutions may be unable to deliver. The most immediate way to allow markets to function as a correction on bad economic policy is through de-institutionalization of fiscal rules and maintaining national sovereignty of fiscal policy. This thesis thoroughly endorses reducing bureaucratization of the currency union and recommends abolishing the hard economic benchmarks of the SGP. Loose policy guidelines in a more federalist economic arrangement are a much more desirable replacement for the strict conditionality of the SGP. In spite of the necessity for fiscal federalism, there is a greater

likelihood that the failure of the Maastricht Treaty and the SGP will lead to more centralization and increasing economic supervision within the Eurozone. Furthermore, transfers of funds or common Eurobonds will only create a moral hazard that will likely lead to future economic mismanagement.

Even though the Maastricht Criteria and SGP sought to strengthen and stabilize the different economies of the Eurozone, they did little to change the legislative environment for genuine reform of government spending. Consequently, few structural changes emerged as a direct result of the Maastricht criteria or the SGP. In addition, problems in Spain and Ireland would reveal that the economic benchmarks of those treaties were deficient and unable to foresee the difficulties that high current account deficits could create.

The Eurozone currently faces tremendous hardship as a consequence of the 2008 financial crisis. The global recession revealed institutional weaknesses in the common currency and has cast doubt on its economic viability. As a result, several countries are at the precipice of defaulting on their excessive debt burdens. A seemingly obvious consequence of the debt crisis in Europe was the loss of credibility the SGP suffered. Events leading up to the sovereign debt crisis, however, were already signaling that the SGP never stood on solid ground. Furthermore, much analysis has shown that not only were the Maastricht Criteria and SGP lacking institutional credibility, they may have even served to work *against* their purported goal of economic integration and stability within the currency union.

The majority of the literature dedicated to the economic crisis in the Eurozone sympathizes with the idea that increasing centralization at the European level would

provide the appropriate environment for economic convergence and stability. However, that assumption tends to ignore the possibility that centralizing the economic norms of the currency union through the SGP and Maastricht Treaty may have been the culprit for the Eurozone's inability to achieve full economic integration. Although the idea of increasing supervision and control over a group of heterogeneous economies is psychologically comforting, excessive conditionality tends to encourage cosmetic reforms for the sake of compliance, which consequently distorts the incentives of economic policy makers.

The most likely way for the Eurozone to achieve fiscal stability and convergence is to allow for fiscal federalism by softening the rules of the SGP and allowing the corrective forces of the market (e.g. high interest rates on sovereign bonds) to provoke an endogenous political will necessary to alter the flawed economic structures of the euro area's bad economic actors. The disaster that would ensue as a result from exiting the currency union should dissuade any heavily indebted Member State from leaving the euro area. As a result, Eurozone members have sufficient political capital to refuse bailouts and allow for the default of Member States if necessary.

The Eurozone core is reticent to allow for default because their banks hold much of the bad debt that peripheral countries accumulated and are struggling to pay. If the peripheral Member States default on their obligations, the losses banks would incur could pose a systemic risk to the core economies of the Eurozone. The fear of contagion, however, overlooks the fact that recent stress tests found most banks would be solvent in the event of an economic crisis and are continuing to accumulate more cash in reserve (European Banking Authority 2011). Furthermore, it is becoming increasingly apparent

that a Greek default is certain. Delaying that inevitability would probably do more harm than default through debt restructuring.

Monetary and Fiscal Policy:

Under the Maastricht Treaty, the European Central Bank (ECB) gained full authority over monetary policy and the responsibility to maintain price stability in the Eurozone. To meet those requirements, the Treaty ensured the independence of the monetary authority from political pressures by policy makers. The Treaty prohibited monetization of public deficits and "[safeguarded] institutional, personal, functional and financial independence of the ECB's decision-making bodies" (Torres, Francisco S. 2006). Throughout the 1970s and 1980s, restrictive monetary policy allowed Germany to maintain lower inflation rates than its European neighbors. Upon adopting German style monetary policy, price level increases in Europe began converging from 1985 onwards (Scheremet, Wolfgang 2000).

Along with the political salience of Germany's restrictive monetary policy came an uncertainty about the economic circumstances of the soon to be members of the euro area. While Germany enjoyed low inflation rates and relatively stable fiscal policies, many other prospective members did not share the economic discipline of Europe's strongest economy. As a result, there were strong political and economic incentives for Germany to avoid entering an arrangement that could adversely affect its economy. That

concern led German policy makers to become the architects of the treaties and institutions within the currency union.

The Barro-Gordon model explained that when a high inflation country and a low inflation country enter into a monetary union, the high inflation country could gain a better reputation by virtue of association with the lower inflation country. Another possibility the Barro-Gordon model accepted was that that the country with lower inflation could have its reputation suffer as a result of being in a currency union with a high inflation country. In order to mitigate the reputational losses from such an association, the country with lower inflation would decide to impose various conditions before joining a monetary union. The Barro-Gordon model illustrated the dynamic behind Germany's insistence on economic conditionality prior to adoption of the euro (de Grauwe, Paul 1996).

As a result of imposing disinflationary policies on potential members of the currency union, "a temporary increase in the unemployment rate will be inevitable (a movement along the short-term Phillips curve)"[1] (de Grauwe, Paul 1996). Furthermore, the willingness of a country to endure some pain in order to meet convergence criteria does not guarantee future disinflationary policies. By virtue of their earlier disinflationary policies, the Greek or Portuguese ECB representatives may choose to encourage more inflationary policies at some point in the future. That uncertainty led de Grauwe (1996) to conclude that using convergence on inflation as a condition for membership was possibly harmful. Countries with higher amounts of debt may have a greater incentive to create "surprise inflation" as a means of maximizing employment and fostering economic

[1] The theory that there is an inverse relationship between inflation and unemployment.

growth. De Grauwe (1996) concluded that reducing debt to GDP prior to adopting the euro was a more constructive condition than convergence on inflation.

De Grauwe (1996) claimed that the Maastricht criteria made convergence more difficult for the weaker economies of the Eurozone. The inflation requirement created difficulties towards meeting the debt requirement because if a Member State's disinflationary policies lack credibility, it would become difficult to lower inflation expectations, which would keep nominal interest rates high. However, as inflation goes down and nominal interest rates remain high, real interest rates increase, which would also increase the real value of the debt (de Graue 1996). The main implication of that phenomenon is that true convergence on public debt and deficits is probably more likely in the absence of convergence criteria.

De Grauwe (1996) found that allowing membership into the Eurozone without imposing Maastricht Criteria would facilitate the ability for Member States to meet the budget deficit norm of the Maastricht Treaty. His solution for that paradox was to put more emphasis on the ECB's responsibility to maintain price stability instead of the bureaucratic imposition of economic conditionality. Strengthening of euro area's monetary institutions is more influential in creating monetary stability than imposing convergence requirements (de Grauwe, Paul 1996). Gros (1995) also suggested removing fiscally irresponsible countries from the decision making apparatus of the ECB, which would assuage any concern about some countries negatively influencing monetary policy in the Eurozone.

The fiscal limitations of the Maastricht Treaty and subsequent SGP also applied pressure on the viability of the European social welfare model. In 1997, Member States

agreed to apply a loose coordination of social welfare policy outlined in the Open Method of Coordination (OMC) (Attia, Nicole 2007). Boeri (2002) discussed the merits of harmonizing social policy in the Eurozone and concluded that de-centralization was likely to be more preferable than transnational harmonization because "local provision of social security can better exploit local information and deal with the large informational asymmetries jeopardising the effectiveness of redistributive policies." Boeri (2002) did concede, however, that there were potential benefits to soft coordination on policies, such as establishing common standards "to estimate the debt of public pension systems, [developing] social policy expenditure projections and [providing] general accounts which can best isolate the various (often improper) functions played by public pension in the EU countries."

Neo-Keynesian[2] critics derided the budget constraints the Maastricht criteria and the SGP imposed on national governments because of the difficulty it created in using countercyclical fiscal policies as a method of stabilizing national economies. Nevertheless, Gali and Perotti (2003) found that Eurozone countries had more procyclical fiscal policies prior to ratification of Maastricht. They also observed that the decline in total government investment in the economy within the euro area mirrored trends in industrialized countries around the world. Furthermore, that trend was underway before the ratification of the Maastricht criteria. In light of Gali and Perotti's findings, neither the Maastricht Treaty nor the SGP seemed to be responsible for the reductions in government expenditures throughout the euro area. However, Gali and Perotti (2003)

[2] Economic theory developed by British economist, John Maynard Keynes, explaining that government spending stimulates economic activity and mitigates the hardships that arise as a result of recession or depression. A major feature of Keynesian economic policy is "counter-cyclical" government spending. For example, during an economic downturn, government purchases should go up, while taxes should go down and during periods of economic growth, government spending should go down, while taxes go up.

admitted that there were no major recessions during the sample period they studied, so they conceded that different circumstances could have changed the results of their study.

Attia and Bereger (2007) found that there indeed was "a process of conditional convergence" within the euro area and that the Maastricht criteria curbed the rate of growth on social expenditures. However, their study did not account for trends in the developed world that seemed to mirror those in the Eurozone, making it unclear as to whether the Maastricht Treaty was responsible for contraction in social welfare expenditures.

Unlike Gali and Perotti (2003), Fatás and Mihov (2009) found that fiscal policy in the euro area actually became more procyclical during the Maastricht period. They did agree, however, that the SGP did little to influence fiscal policy. They also argued that since monetary union created a distinct risk of asymmetric shock[3], the goal of fiscal synchronization outlined in the SGP made it difficult to utilize different national fiscal policy responses in the event of such a shock. As a result, homogenization of economic policy increased the risk of asymmetric shock within the monetary union (Fatás, Antonio and Mihov 2009).

Blavoukos and Pogoulatos (2008) explained that the Maastricht criteria imposed "hard conditionality," whereas the adoption of the SGP after the establishment of the Eurozone was a much softer form of conditionality because the acceding countries already achieved their goal of membership in the euro area. Exogenous constraints ("push factors") did little to ensure fiscal sustainability, whereas endogenous pressures ("pull factors") created the environment for enacting necessary structural reforms toward

[3] An asymmetric shock is when there "is a sudden and dramatic drop in investment demand in an EU country which does not, however, affect the aggregate demand of the other countries" (Di Gennaro, Luca 2005).

establishing fiscal sustainability. When reforms were perceived to be imposed externally, domestic support was weak and thus created the risk of future compliance issues. Although exogenous influences may insulate political leaders from electoral pressures, they also create an environment for shallow reforms. In their study of the four southern European states: Italy, Spain, Greece, Portugal (SE-4), they found that much of the fiscal adjustment that occurred during the Maastricht era did not survive long after adoption of the euro.

The Maastricht criteria's emphasis on fiscal "consolidation" instead of fiscal "sustainability" allowed for a "[reliance] on macroeconomic policy reform without the need to engage in substantial structural reforms that involved much higher political cost for the incumbent government" (Blavoukos, Spyros and Pogoulatos 2008). The more substantive structural reforms would have involved more politically sensitive issues "such as transfers, subsidies and government wages" (Blavoukos, Spyros and Pogoulatos 2008). If the will to address such politically delicate issues comes exogenously, the likelihood of backsliding increases (Blavoukos, Spyros and Pogoulatos 2008).

Blavoukos and Pogoulatos (2008) explained that accounting for "quality of adjustment" as a benchmark of conditionality policy would have been much more effective than the imposition of numerical targets. The evidence of the fiscal crises within the euro area shows that the Blavoukos and Pogoulatos (2008) recommendation would have fared much better. Higher quality structural reforms also tend to be politically risky. It is possible that the reward of entry into the Eurozone could have muted any political fallout that would have ensued otherwise. Nevertheless, imposing drastic structural reforms after adopting the euro may be politically difficult considering that leaders can

no longer use the reward of Eurozone membership as a justification for their policies. In addition to the fact that many Member States had structurally unstable economies, their prospective economic troubles came to pose a risk to the stronger economies within the monetary union as well. The main cause of contagion was that banks throughout the Eurozone held and continue to hold the sovereign debt of the peripheral countries. Therefore, missed or delayed payments created the threat of a major banking crisis in the Eurozone core.

Kenen (2000) explained that the costs of one country's default would shift to other countries within a monetary union. Membership in a common currency may lead governments "to neglect the side-effects of their own fiscal policies and borrow more than they would if they were made to internalize the full effects of their policies" (Kenen, Peter B. 2000). In order for the Eurozone to survive the economic indiscipline of Member States, it must allow them to suffer the consequences of their policies without intervening. As Blavoukos and Pogoulatos (2008) explained, external pressures provide insufficient motivation to sufficiently alter domestic economic policies.

Hallerberg and Bridwell (2008) argued "that the effects of the Stability and Growth Pact have been asymmetric" and that the structure of the government influences the effect of fiscal rules on a given country. The SGP "serves a useful function in fiscal contract states, where it reinforces the domestic fiscal institutions based on fiscal targets. It has no real effect, however, on delegation states. Such states were more likely to have excessive deficits and to ignore explicit Commission recommendations" (Hallerberg, Mark, and Bridwell 85). In a delegation state, political actors delegate decision making responsibilities to a high ranking bureaucrat (e.g. finance minister) in what is usually a

government with single party control. A contract state, however, relies on coalitions to build fiscal contracts. In the contract system, ministers "effectively become managers of ministries that already have their spending mandates predetermined" (Hallerberg, Mark and Bridwell, 75).

They also found that larger states tended to have higher deficits and were less likely to comply with European Commission recommendations. Nevertheless, they concluded that all euro area states increased their fiscal discipline to varying degrees since 1999. Hallerberg and Bridwell (2008**)** argued that the perception of fiscal recklessness is a product of Member States being unable to live up to the high standards of the SGP rather than a result of genuine backsliding. As this thesis will show, however, some states lacked sufficient fiscal discipline to prevent their debt crises from materializing. Subsequent information will also reveal that even the core economies of the Eurozone also had issues complying with the fiscal rules they imposed.

Hallerberg and Bridwell (2008) found that Member States reached fiscal convergence in the years following the Maastricht Treaty, but they also observed a "clustered divergence in fiscal policy outcomes" in which there was a certain group of states that was able to maintain or achieve fiscal stabilization and another group that was not. Although convergence may have been achieved on a larger scale, significant differences persisted from country to country. The SGP emerged in order to assuage concerns about the credibility of Article 103[4] of the Maastricht Treaty, but it ultimately did little to prevent the sovereign debt crisis.

In spite of the fact that the no-bailout clause of Treaty on the Functioning of the European Union (TFEU) was an important trait of the Eurozone's structure, its credibility

[4] No-bailout clause

was also in doubt. The 2010 transfers[5] to Greece to help service its debt responsibilities confirmed those doubts. Even though the TFEU prevented Member States from assuming the debt of other Member States and prevented the ECB from directly monetizing any sovereign debt, it never specifically banned the practice of low interest cash transfers/loans from one Member State to the other (Paliouras, Vaileios). Nevertheless, the transfers effectively undermined the spirit of the no-bailout clause. Explicit violation of the no-bailout clause came later when the ECB initiated sovereign debt purchases throughout the economic periphery of the Eurozone (Sapir, Andre, Pisani-Ferry and Darvas 2011).

In light of the sovereign debt crisis, the establishment of a European level institution in charge of banking supervision and regulation became a more realistic possibility. Prior to the crisis, Member States opposed the idea because "it would amount to the pooling of risks associated with bank failures" (Sapir, Andre, Pisani-Ferry, and Darvas 2011). However, the financial crisis showed "that the absence of such institutions imposes an even bigger burden sharing on countries, especially within the euro area where the ECB has been made to act as the lender of last resort to banks that may turn out to be insolvent" (Sapir, Andre, Pisani-Ferry, and Darvas 2011).

Although fiscal federalism is essential for the economic success of EMU, regulatory imbalances throughout the union created catastrophic distortions that led to excessive lending and an eventual systemic risk in some Member States. As a result, this thesis accepts the premise that some degree of European level banking regulation is necessary in order to avoid the excesses that led to the debt crises in some peripheral Member States.

[5] In the form of low interest loans

The Politics of EMU:

Gabel (1999) examined the dynamics of public support for EMU among EU citizens and found that poorer citizens who depended on cash transfers from the government were less likely to support EMU. Workers who were employed in more trade sensitive sectors of the economy were also less likely to support monetary union as well. On the other hand, residents of border areas were more likely to endorse the idea than people who lived inland. Moreover, "as the value of cross-border shopping increases, the margin increases by which border resident more strongly prefer EMU than non-border residents" (Gabel, Matthew J. 1999). There was no correlation between public sector worker sentiment and their country's public debt as a percentage of GDP. Generally, respondents were more likely to support EMU if their country had higher debt levels, higher levels of inflation, and longer period of membership in the Exchange Rate Mechanism (ERM), which preceded EMU (Gabel, Matthew J. 1999). The results showed that citizens of Member States made nuanced economic considerations prior to forming their opinions on the common currency.

Kaltenthaler and Anderson (2001) found that European voters' opinions on EMU were more sensitive to certain economic indicators, "such as inflation, unemployment, and trade, but not on the relative independence of their country's institutions of central banking." Respondents from countries that had higher levels of inflation were more likely to support EMU because they perceived the arrangement as a check on inflation. In addition, countries that had higher levels of unemployment also tended to be more supportive of EMU. Respondents from countries that traded more with European partners

were also more likely to support a common currency. Like Gabel (1999), Kaltenthaler and Anderson (2001) found that countries belonging to European institutions for longer periods were more likely to support EMU as well. Overall, Kaltenthaler and Anderson (2001) found that people who had a stronger sense of national identity were opposed to joining the euro area, while individuals with more utilitarian economic interests were more supportive of the common currency (Kaltenthaler, Karl C. and Anderson 2001).

Knoester and Kolodziejak (1992) maintained that the Maastricht convergence criteria were inadequate because they never emphasized supply-side economic policies as a method of reducing debt. Instead, Maastricht allowed for tax increases to cover for massive public sector spending as a more politically expedient route toward reducing deficits and debt. Nevertheless, Kenen (2000) observed, "that a monetary union may raise factor mobility, especially capital mobility, which would make it harder for national governments to impose taxes necessary to avoid large budget deficits" (Kenen, Peter B. 2000). Consequently, EMU put greater pressure on countries to curb spending instead of pursuing revenue increases through taxation—even though the generous European social welfare model applied political pressure on countries to maintain spending on the social safety net. The implication is that while political and economic realities keep governments from imposing higher taxes, there are political pressures to maintain the welfare state as well.

High spending and insufficient revenue was an especially distinctive feature of the Greek economy. The reason Greece had the lowest level of tax revenue in EU was because the tax code was progressive to the point of encouraging individuals to become self-employed in order to underreport their earnings. Self-employed individuals paid a

much smaller share of taxes into the social security system, but enjoyed the benefits of the social safety net while incurring few of the costs. Under the Greek tax structure, high middle income earners incurred much higher tax rates than middle to lower-middle income earners. In a system where more than half of wage earners pay no income taxes, the political cost of undoing the excessive progressiveness of the tax system would be too high (Mitsopoulos, Michael and Pelagidis 2011).

The reticence to reform the fiscal structure of a country out of fear of political reprisal illustrates the negative policy biases[6] regarding fiscal policy. Conversely, political leaders have positive policy biases that adversely affect a government's fiscal position as well. The most salient positive policy bias exists in the desire to increase government spending during election years in order to artificially and temporarily maintain or increase social welfare benefits. This form of fiscal activism is one of the more distinctive features of economic policymaking in democratic countries.

Afonso (2005) collected data on government expenditures in the run-up to parliamentary elections during the period from 1970 to 2003[7] and found that government underwent noticeable expansion during election seasons. Mink and Haan (2006) also discovered that, on average, budget deficits increased by .96% of GDP during the runups to elections. Golinelli and Momigliano (2006) also found strong evidence of a political budget cycle in the euro area that amounted to a fiscal expansion of about 1.4% of GDP on an average election year (Golinelli, Roberto and Momigliano 2006).

[6] "Negative" policy biases arise from political pressures that create a bias towards inaction, while "positive" policy biases arise from political pressures that create a bias towards some kind of legislative action.
[7] Portugal and Spain did not have democratic elections until 1975 and 1977 respectively (Afonso, Antonio 2008)

The ideological composition of the government also influenced the amount of spending during an election year. Left leaning governments were more likely to embrace Keynesian fiscal expansion and greater social expenditures. Mink and Haan (2006) added that the motivation to curb spending might have been greater for prospective Eurozone countries prior to adoption of the euro. Upon gaining entry into the euro area, however, the SGP may not have had the same coercive power as the Maastricht Treaty. They surmised that fiscal contractions leading up to adoption of the euro provided more flexibility to engage in less disciplined fiscal policy after adopting the euro (Mink, Mark and Haan 2006).

The 1993 European Commission White Paper called, "Growth, Competitiveness, Employment" stressed the importance of controlling unemployment as the "center of political attention" (Frieden, Jeffry A., Gros and Jones 1998). The paper went on to state that European competitiveness would come at the cost of maintaining a munificent welfare state within Europe. By 1994, the "Reflection Paper" published by the German Christian Democrats emphasized the fact that few countries were actually qualified to enter EMU (Frieden, Jeffry A., Gros and Jones 1998). The election of Jacques Chirac in 1995, who ran on a platform of helping "the unemployed and socially excluded," called into question any fiscally disciplined measures toward achieving convergence (Frieden, Jeffry A., Gros and Jones 1998). Nevertheless, the exchange rate crises of 1995 illustrated the need for stability, and Jacques Chirac agreed to the tighter fiscal criteria proposed by German Finance Minister and author of the SGP, Theo Waigel. However, "in response to a tightening of fiscal reform measures, France erupted in a series of

strikes against the government's policy and, by extension, against EMU" (Frieden, Jeffry A., Gros and Jones 1998).

Protests in France are evidence of the political difficulties related to fiscal consolidation. Outside forces ultimately forced French leaders to reform their fiscal policy and it suffered public legitimacy issues as a result. Excessive bureaucratization at the European level will do nothing to assuage disenchanted voters who have yet to feel the pain of their country's fiscal mismanagement. Furthermore, transnational regimes that transfer funds (on a conditional basis) to Member States in crisis reduce the likelihood of popular support for domestic reform.

Although the purpose of the IMF is to resolve the problems that afflict several euro area countries, there remains a strong motivation to solve the fiscal crises without the help from non-EMU sources. Bofinger and Ried (2010) observed that "the strongest argument is a feeling of European federalism that would be violated once the IMF interferes: since the IMF is not called when California has liquidity problems, it should not be called when Greece does either" (Bofinger, Peter and Ried 2010). However, they subsequently admitted that the comparison to US states was not completely analogous.

Apart from the moral hazard that the IMF creates by virtue of its existence, its role as a safety net for the euro area undermines the spirit of the no-bailout clauses. Having a guarantor of debt at any level creates the possibility for free riding within the Eurozone despite the fact that there may be no framework in the arrangement that allows for a bailout. Therefore, a Member State may continue reckless fiscal policy within the euro area because it has a safety net outside of the currency union. New rules within the monetary union should prevent countries from seeking support outside of the

arrangement in order to truly prevent future cases of economic free-riding. Violation of fiscal rules, however, is not a policy that is excusive to the smaller economies of the Eurozone.

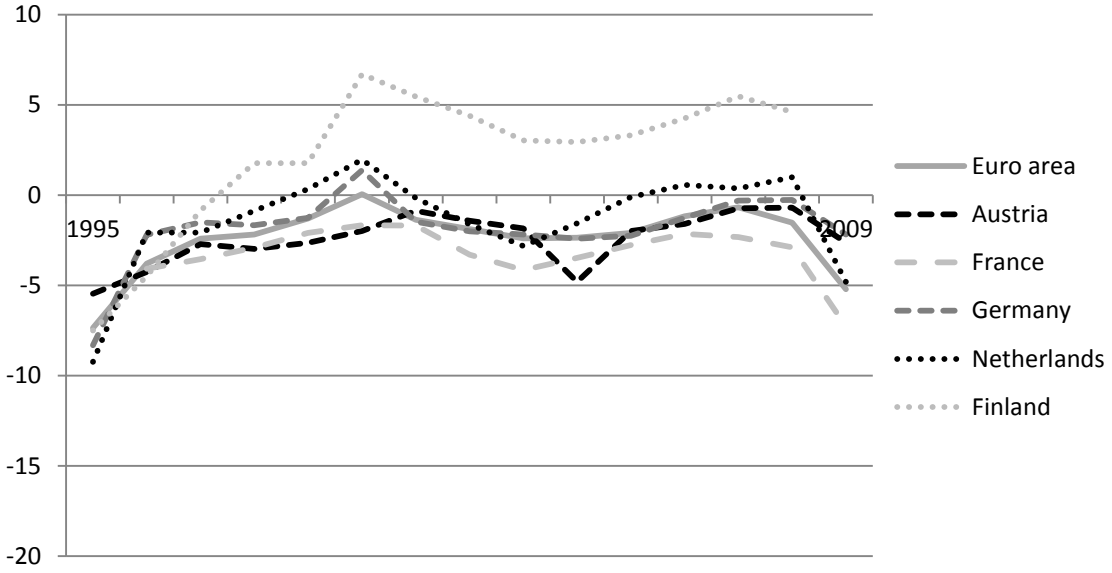
Chang (2005) explained that the size of a country was a strong determinant of its economic interests and its corresponding policies. Larger economies have an easier time running counter-cyclical policies than smaller economies, which makes the SGP much more burdensome for those smaller economies. In addition, the structure of EMU assigns greater voting weight to larger countries in the Council of Ministers, which means that there are possible political costs associated with voting against the larger countries as well. Chang (2005) also found that large countries are also less likely to incur reputational costs for breaking rules than small countries (Chang, Michele 2005).

Buti (2004) claimed that as soon as 2002, the SGP started unraveling as fewer members of the Eurozone adhered to the rules. By 2002 Germany and Portugal (and later, France) had deficits exceeding the 3% of GDP threshold of the SGP (See figures 1.1. and 1.2). According to SGP regulations, they should have incurred disciplinary action, but "When the Commission recommended this course in November 2003, the Council demurred by suspending decisions on whether the next stage of sanctions should be imposed on France and Germany" (Buti, Marco 2004).

Larger Member States are better equipped to "manipulate the rules due to institutional structures that give more voting weight to large states and norms that have made [France and Germany] the leading voices for monetary integration for decades" (Chang, Michele 2005). In 2005, German Chancellor, Gerhard Schroeder sought to

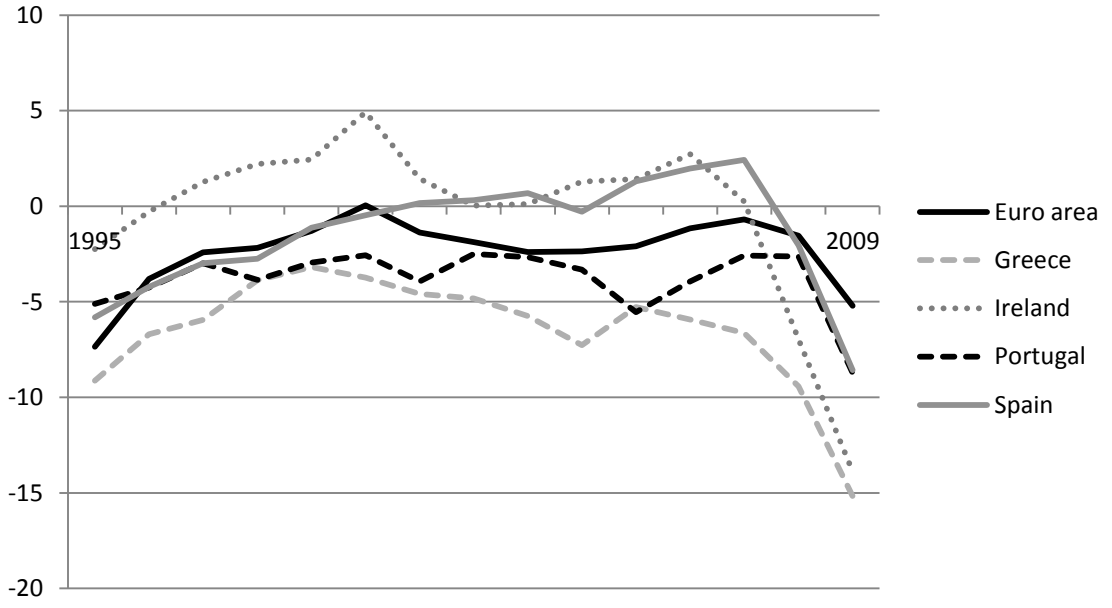
reform the SGP by adding certain qualitative exceptions to its budgetary constraints. He

Figure 1.1: Budget Surplus as % GDP (AAA Rated Eurozone Countries)



Source: World Bank Statistics

Figure 1.2: Budget Surplus as % GDP (PIGS Countries)



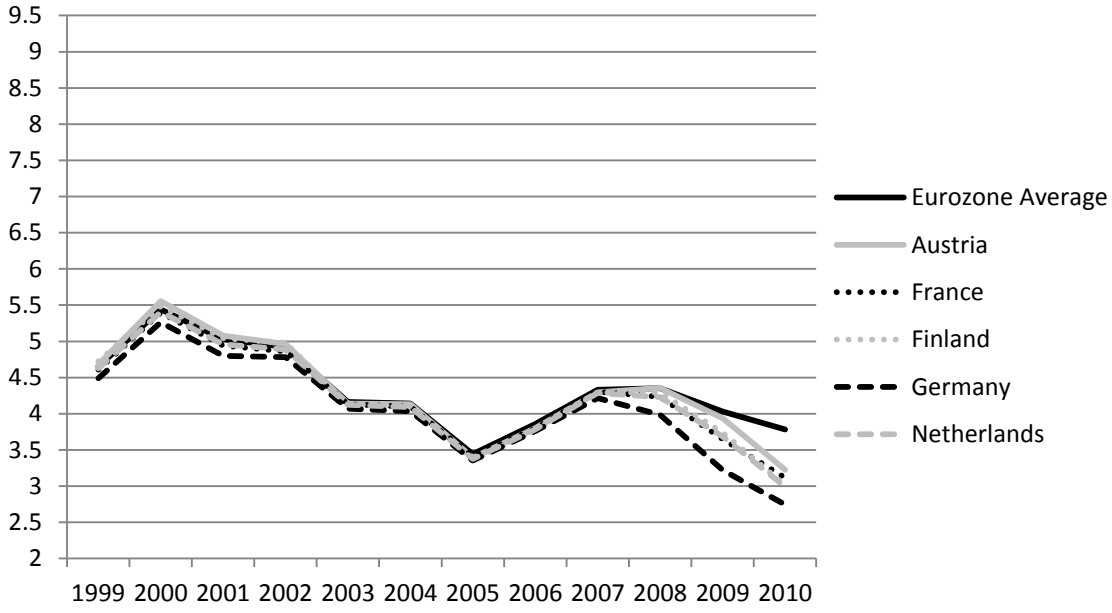
Source: World Bank Statistics

wanted the SGP to consider "quality of expenditures" to prevent any possible sanctions Germany would incur as a result of violating SGP fiscal rules. Schroeder was able to get the concession he wanted by "[offsetting] reunification costs at 4 percentof GDP a year" (Chang, Michele 2005). The violation and subsequent manipulation of fiscal benchmarks by the core economies of the Eurozone perpetuated an environment of economic mismanagement in the periphery and revealed that a reliance of standards through transnational bureaucracies allows more influential members to ignore the rules without fear of reprisal.

Sovereign Bond Spreads in the Eurozone:

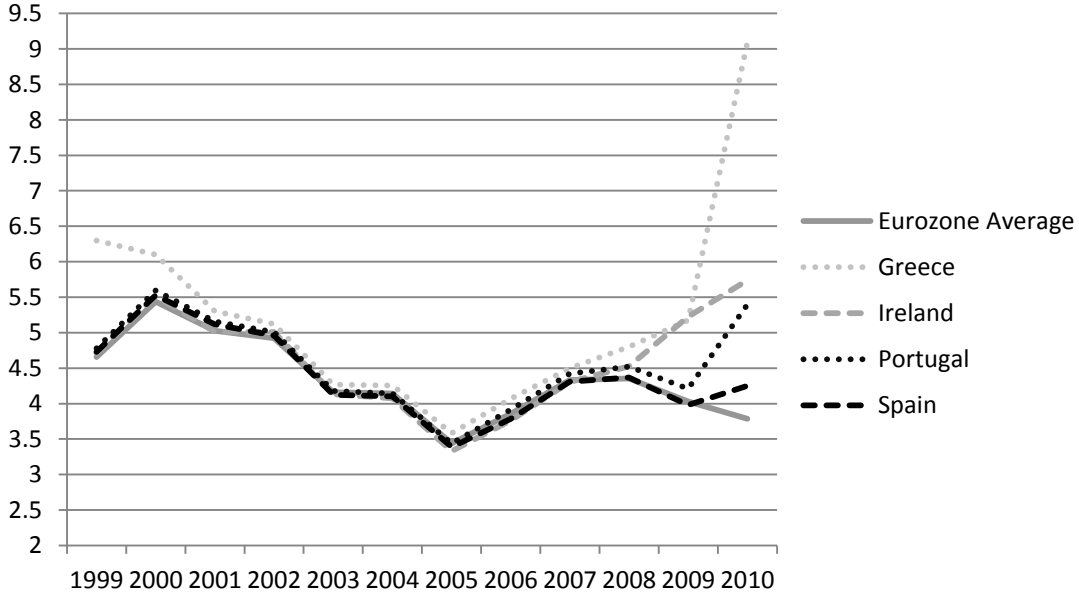
In light of the problems that emerged from the credit crisis of 2007, "financial markets were gripped by a 'flight to risk'" in which the perception of risk was low and investors flocked to assets that were traditionally less safe. Rating agencies perpetuated the flight to risk by illicitly assigning top ratings for assets that did not merit them. As a result of the crisis in the financial system in 2008, markets reacted with a "flight to safety", which had "profound implications for the workings of the government bond markets in the Eurozone" (de Grauwe, Paul 2009). Markets flocked to traditionally safe assets such as US, French, and German sovereign bonds, which lowered their interest rates relative to other, less robust economies (de Grauwe, Paul 2009). While sovereign bond yields were going down in the stronger economies, they were rising in the weaker ones (See figures 2.1 and 2.2).

Figure 2.1: 10 Year Sovereign Bond Yield % (AAA Rated Eurozone Countries)



Source: International Financial Statistics

Figure 2.2: 10 Year Sovereign Bond Yield % (PIGS Countries)



Source: International Financial Statistics

In the year since the financial crisis of 2008, interest rates on sovereign bonds of Greek, Portuguese and Irish debt increased dramatically. Apart from imposing fiscal inflexibility, high interest rates on sovereign debt create negative externalities, because rescuing banks in countries with higher bond yields makes subsequent bailouts of banks more expensive than they would otherwise be. Consequently, "This is likely to lead to further weakening of economic activity in these countries with possible feedback again on the banking system, on the government budget deficits and on the ratings applied by the rating agencies" (de Grauwe, Paul 2009).

In order to eliminate the adverse effects of sovereign bond yield differentials in the euro area, de Grauwe and Moesen (2009) recommended issuing "euro denominated bonds that would be guaranteed collectively by the governments of the Eurozone" (de Grauwe, Paul 2009). The interest rate on the common Eurobond would simply be the weighted average of the yields of every Member State at the time of the purchase. The common Eurobond would allow Germany to continue to benefit from its low borrowing costs, but also allow the weaker economies of the euro area to have easier access to capital without imposing burdens on any other Member States (de Grauwe, Paul and Moesen 2009). They explained that an advantage of issuing such bonds is that countries that now face higher yields would have an easier time financing their stimulus programs.

An elegant version of the Eurobond is the Weizsacker and Delpla (2010) Blue Bond proposal. They recommended pooling up to 60% national debt to GDP of all Eurozone countries, which would reduce the interest rate on sovereign bonds. Member States would have to repay the Blue Bonds in full before repaying any additional debt—Red Bonds—that it would issue once it borrowed over the 60% of GDP threshold. In the

event of a Red bond issuance, "sound procedures for an orderly default" would be in place as well (Weizsäcker, Jakob von and Delpla 2011). The fact that the Red Bonds are not collective, must be repaid after Blue debt, and have a procedure for default accompanying them would lead investors to ask for exorbitant interest rates on those debts. The flight to safety dynamic brought investors to place more of their money in lower risk sovereign bonds, such as Germany's, which brought down average bond yields throughout the euro area. Therefore, debt amalgamation would lower borrowing costs for smaller and less liquid Member States and facilitate the use of fiscal policy as a means of stabilization (Weizsäcker, Jakob von and Delpla 2011).

In a later defense of the Blue Bond proposal, Weizsacker and Delpla (2011) explained that one of the benefits of combining Eurozone debt through Blue Bonds could be the emergence of the euro as an alternative to the dollar as a world reserve currency. If the euro becomes a reserve currency on par with the dollar, then demand for the euro could reduce borrowing costs even further and possibly converge at levels lower than Germany's. An additional benefit of the proposal is that the Red Bonds would make borrowing so expensive that it would dissuade any additional borrowing on top of the 60% of GDP threshold. It would "[complement] the Stability and Growth Pact rules." Weizsacker and Delpla (2011) proposed that the Red bonds "should be largely kept out of the banking system so that Red Bonds could plausibly form the basis for the planned orderly default mechanism in the euro area." The ECB would not be able to monetize any Red debt. A mechanism for an orderly default is a much better alternative to the ad hoc and seemingly dysfunctional procedures the Eurozone has engaged in to address the sovereign debt crisis. The Red Bond structure would remove the incentive for banks to

purchase sovereign debt above the 60% of GDP threshold that they had been willing to finance leading up to the debt crisis.

The problem with the Blue Bond proposal is that there is always a possibility that political pressures would make leaders increase the borrowing threshold of the Blue Bond in times of crisis. Retorting that "the independent stability council would assure that no Blue Bond allocations are ever put to vote in national parliament beyond the 60 percent limit according to its statutes" is insufficient because it assumes that the independent stability council would have the political will to maintain the borrowing limit once a country reaches debt at 60% of GDP (Weizsäcker, Jakob von and Delpla 2011). The proposal seems to lean on the same assumption framers of the SGP relied on in its no-bailout clause; primarily the idea that leaders would stand firm in defense of the rules and be willing stomach the economic (and political) pain that would come as a result. Of all the Eurobond proposals, however, the Blue Bond does make an effort to reinforce the integrity of the SGP and provide some kind of orderly default, which is currently lacking in the euro area.

The problem with any kind Eurobond is that it amounts to little more than treatment for a symptom. The causes of excessive debts are the diverging macroeconomic structures of the Eurozone periphery. High bond spreads within the union are a reflection of those problems and a common Eurobond would only mask those problems temporarily. De Grauwe and Moesen (2009) also admitted that the common Eurobond would create a free-riding phenomenon whereby southern European states and Ireland would have less incentive "to conduct sustainable fiscal policies. As a result, the

countries with low spreads, and especially Germany, may have to bail out the governments of these countries in case of default" (de Grauwe, Paul and Moesen 2009).

Although a common Eurobond would reduce sovereign bond spreads, rule violations would persist under such a framework as well. Kosters (2009) observed that the common Eurobond ignored the no-bailout clause of Article 103 and created such a moral hazard that "from now on every other EMU member state could also count on such a bail-out if it could threaten bankruptcy" (Kosters, Wim 2009). Kosters added that high deficit and high inflation states that entered monetary union never believed the no-bailout clause was a credible feature of the monetary union because "State bankruptcy of an EMU member was not considered very probable since it would have negative effects not only on the country in question but also on the other members as well as on the euro" (Kosters, Wim 2009).

There are also several practical issues pertaining to the implementation of the common Eurobond. One of those problems is that the common Eurobond yield could converge at the rate closer to the country with higher sovereign bond rates than the ones with the lower rates "because common Eurobonds are structured products presently mistrusted" (Kosters, Wim 2009). Bond yields for sound euro economies may go even higher if bond purchasers fear that stronger euro states would have to shoulder the burden of an eventual bailout of the weaker Eurozone countries regardless. There may be political impediments to the Eurobond as well. Voters in stronger euro area economies may become more hostile to the concept of a common Eurobond because it would essentially ask German, French and Dutch tax payers to shoulder a higher price for their country's borrowing in order to support the spending habits of other members.

Issing (2009) insisted that the best way to combat high bond spreads within the Eurozone was simply for weaker economies to become more fiscally responsible. He explained that the existence of the euro denominated bond "would foster the illusion that it is possible for a country to get out of difficulty without having undertaken fundamental reforms" (Issing, Otmar 2009). Furthermore, Kosters (2009) welcomed bankruptcy over a bailout or common Eurobond because bankruptcy facilitated long-term stability. He explained that a false sense of solidarity within the euro area provided the "incentive for lack of discipline, destroying EMU in the long run" (Kosters, Wim 2009).

The common Eurobond would be a bad idea for all of the reasons Issing (2009) and Kosters (2009) explained. It is a more subtle form of mutual support, which would perpetuate the same kind of moral hazard that would arise from an institution guaranteeing a bailout in times of financial distress. Furthermore, the Eurobond would hide the necessary signals that a high sovereign bond interest rate delivers. A high interest rate forces governments to alter their fiscal policy in order to avoid economic ruin. Along with a credible no-bailout clause, high interest rates provide the perfect disincentive for fiscal irresponsibility. The Blue Bond proposal is admittedly the best Eurobond proposal and the only one that directly attempts to rectify the credibility gap endemic in prior agreements, but it rests on the defunct assumption that European institutions will uphold their rules when faced with politically sensitive ultimatums.

From its inception, rule breaking was a recurring phenomenon within the EMU framework. Greece gained admission after its government deliberately forged convergence criteria numbers. Along with other Eurozone members, Greece continued fixing its economic data through "creative accounting" practices, such as underreporting

military expenditures, overstating social security surpluses, "off balance sheet borrowing by guaranteeing obligations of state-owned enterprises, interest rate swaps that reduce current borrowing costs by transferring the additional burden to the future or hiring private banks to construct deficit-hiding devices" (Paliouras, Vaileios). Furthermore, Germany and France sought to prevent an early warning and an excessive deficit procedure against them after they exceeded the 3% deficit-to-GDP limit. Ultimately, they avoided the fines by changing the rules of the SGP in their favor (Kosters, Wim 2009). In fact, the larger European economies had issues complying with SGP requirements long before the debt crisis surfaced in the Eurozone periphery

Although the "Suspension of the excessive deficit procedure against Germany and France, [may have signaled] the amputation of the dissuasive arm of the Pact," the preventative arm was losing credibility as well, "as evidenced by persistent negative gaps between fiscal projections and the outcomes of successive rounds of stability programmes" (Buti, Marco 2004). Buti (2004) blamed the three largest Eurozone countries "for the credibility gap affecting stability programmes, as their fiscal projections can be shown to suffer a significant bias to under-predict actual deficits." The inability to adhere to the Eurozone rules was a widespread phenomenon. Establishing rescue mechanisms to reconcile the reputational damage of rule-breaking will only perpetuate future compliance issues.

Eurozone institutions should not operate to assuage the fears of economically inefficient and irresponsible countries within the currency union. The best way to maintain economic and institutional integrity of the euro area is to enforce its no-bailout clause and expand it to prevent Member States from using institutions outside of the

arrangement. Fixed numerical benchmarks and fiscal rules do not bring convergence or economic sustainability. Therefore looser and broader policy prescriptions allowing for fiscal federalism—along with the establishment of common accounting standards—should replace the regime of rigid economic goals.

Wages and Labor:

Differences in labor markets create circumstances in which national economies respond to monetary policy in different ways, which is why a symmetric shock may still have asymmetric effects. A shock to a group of countries may require different monetary policy prescriptions in different countries (Gros, Daniel 2003). In his simulation, Tamborini (2006) found that the more asymmetric the shock the Eurozone endures, the less capable the ECB would be in stabilizing it. The likelihood then becomes that "smaller idiosyncratic countries" will be left alone to resolve the effects of such a shock (Tamborini, Roberto 150). Although Viñals and Jimeno (1998) argued that symmetric shocks were much more likely in EMU, asymmetric shocks remained a possibility. They explained that the mechanisms to mitigate the effects of asymmetric shocks are labor mobility, fiscal policy and relative wage flexibility. Unfortunately, labor mobility is an unlikely solution "since the numerous historical, cultural, and linguistic differences across European countries constitute a formidable barrier to international migration" (Viñals, Jose and Jimeno 39). In addition, the "Maastricht Treaty grants only a limited

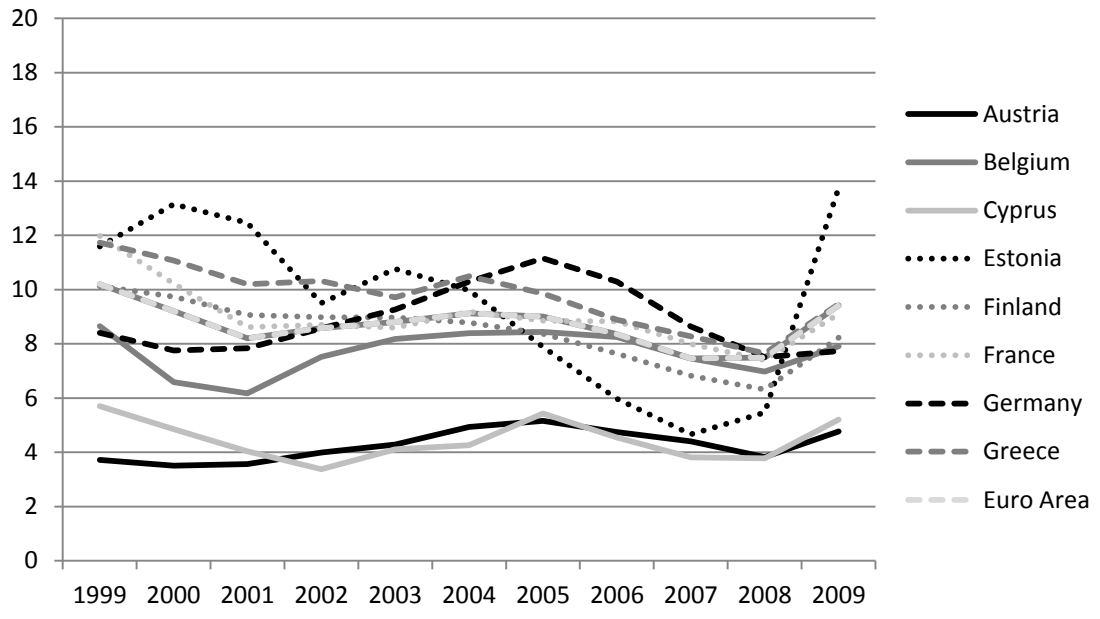
role to national fiscal policies to cushion the impact of real asymmetric shocks" (Viñals, Jose and Jimeno 39).

Wage rigidity[8] also makes withstanding the effects of asymmetric shock more difficult because "structural rigidities in national labor markets make wages respond slowly to worsening economic conditions. Real wage rigidity describes the extent to which unemployment rises as a consequence of inadequate wage adjustment to a real shock" (Scheremet, Wolfgang 2000). Wages need to be flexible enough to go down during recession in order for firms to add to or maintain their labor force. If wages remain overly rigid, natural unemployment will remain high. In fact, many European states continue to struggle with unemployment (See figures 3.1 and 3.2). In order for Member States to withstand the effects of asymmetric shocks, they must undo some of the policies that have been traditionally favorable to unions and allow more wage flexibility to control unemployment. Viñals and Jimeno (1998) concluded that EMU would not aggravate the problems Europe already faces with unemployment, but the limited degree of labor mobility and fiscal policy solutions would make it very difficult for "countries with differentiated economic structures" to deal with asymmetric shocks (Viñals, Jose and Jimeno 41).

Wage policy within EMU is one of the major challenges to Eurozone convergence. Scheremet (2000) concluded that convergence of inflation rates within the euro area could not mask the differences in wage policy setting among states

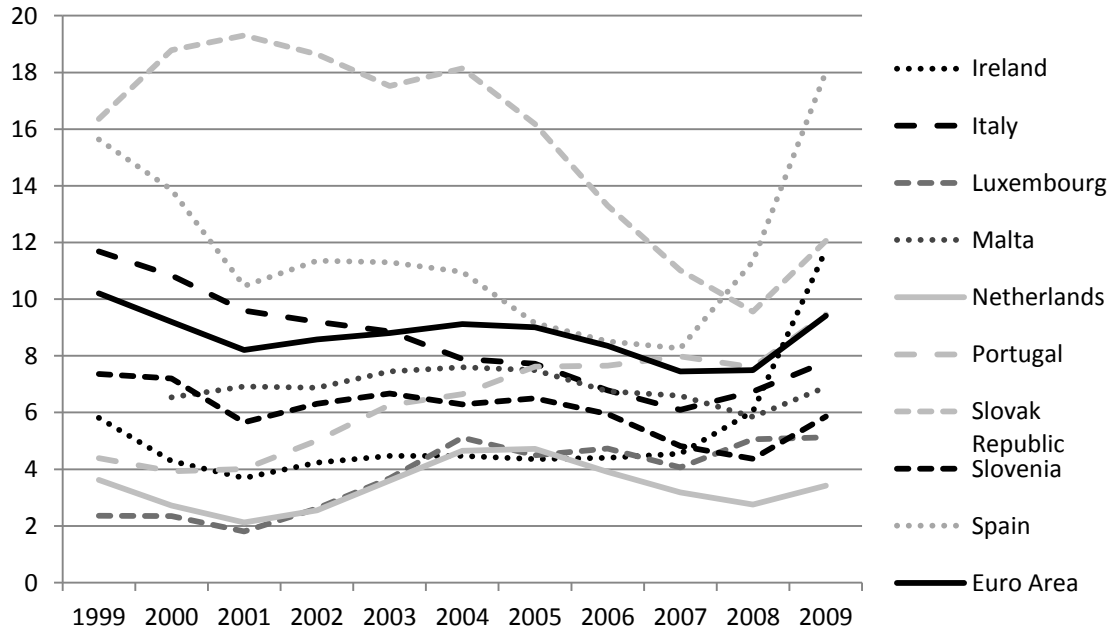
[8] The inability for wages to adjust according to changes in national output. In order to maintain the same levels of employment, wages should adjust downward as output/GDP goes down. Wage rigidity is usually an effect of union negotiated salaries that remain at high levels as a result of binding collective bargaining agreements.

Figure 3.1: Eurozone Unemployment Rates (A-G)



Source: World Bank Statistics

Figure 3.2: Eurozone Unemployment Rates (I-S)



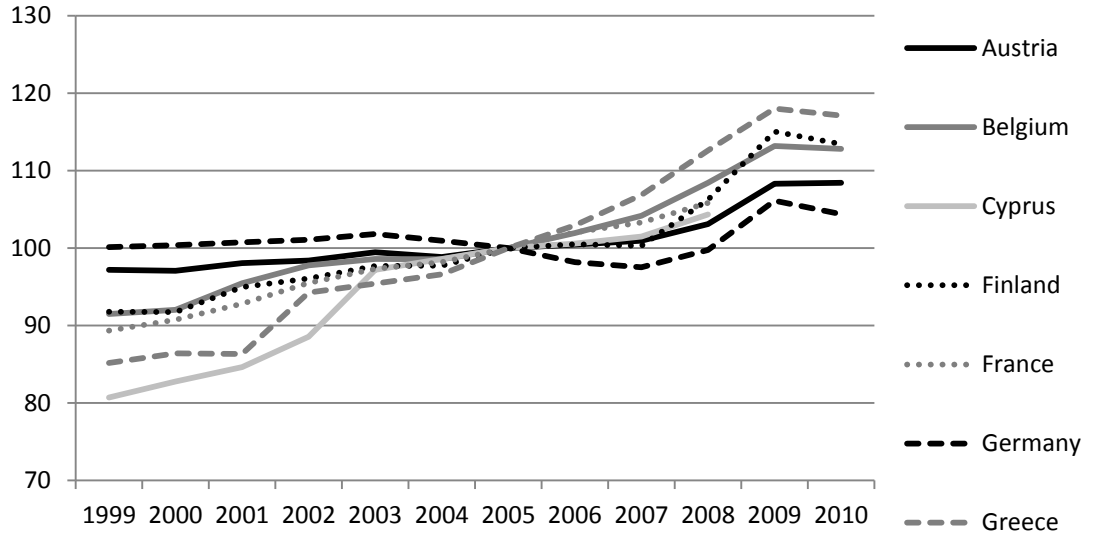
Source: World Bank Statistics

participating in EMU. He also observed that there was large variance in wage formation processes among EU member states. “This concerns not so much the level of wage bargaining (i.e., the company, industry, or national level) as the organizational forms of the unions (i.e., industry, professional or politically oriented unions) as well as the intensity of macroeconomic co-ordination” (Scheremet, Wolfgang 2000). In some states there were “decentralizing” trends in the wage formation process, while in others, a centralizing tendency emerged.

The problem monetary union creates vis-à-vis wage policy is that wage settlements in one state do not necessarily affect ECB policy. The ECB does not change its monetary policy according to the asymmetric shock risks some Member States pose. Therefore, there is less incentive within each state to achieve “national wage moderation” (Dyson, Kenneth H.F. 2008). Instead, there is a “tragedy of the commons” scenario, whereby every Member State neglects policies that allow for flexible downward wage adjustment because it knows other Member States are doing the same, which ends up harming the currency union as a whole. In fact, unit labor costs (ULC’s) were increasing throughout the euro area during the years leading up to the debt crisis (See figures 4.1 and 4.2).

Prior to monetary union, a state would compensate for upward wage rigidity and maintain short term trade competitiveness through artificial currency devaluation. Currently, the relationship between wage policy and monetary policy falls under the purview of EMU, which means that states with upward wage rigidity joined the same group as countries that placed more value on price stability. Interestingly, “The mere anticipation of such restrictions during the process of European unification led to nominal

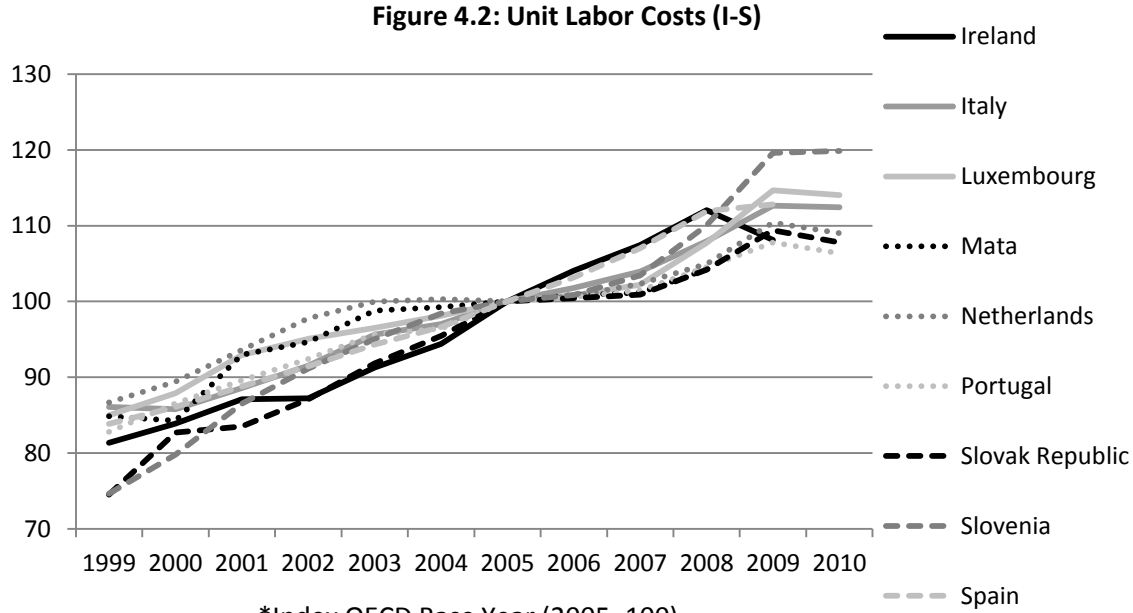
Figure 4.1: Unit Labor Costs (A-G)



*Index OECD Base Year (2005=100)

Source: OECD Statistics

Figure 4.2: Unit Labor Costs (I-S)



*Index OECD Base Year (2005=100)

Source: OECD Statistics

wage increases in the European countries becoming more closely aligned since the mid-1980s" (Scheremet, Wolfgang 2000). Although inflexible wages are an impediment to mitigating the effects of recession and asymmetric shock, generally high wages may not be proximate cause of the problem. Felipe and Kumar (2011) argued that reducing wages would not yield greater economic performance among the Eurozone's economic periphery. They found, however, that the highest increases in ULC's (wages increasing at a faster rate than productivity levels) came from "Greece, Portugal, Ireland, Spain, and Italy (in this order)" (Felipe, Jesus and Kumar, Utsav 2011). They never explained why the five economies with the most significant debt burdens in the Eurozone were also the countries with the highest ULC's. Nevertheless, Felipe and Kumar (2011) explained that there is much more to ULC's than meets the eye. They argued that lowering ULC's to German levels is not necessarily relevant because they produce and export different products.

Germany tends to export much more complex goods such as electronic measuring and controlling apparatus, laser, light, and photon beam process machine tools among others. Germany's export market competes with other developed economies (e.g. US, Japan, Sweden, Switzerland, UK, and Finland) (Felipe, Jesus and Kumar 2011). The PIGS countries, however, export much less complex goods than its wealthier Eurozone partners. Instead, their export markets are more proximate to China's and those of other developing economies, which means that peripheral countries could find ways to reduce their ULC's and would probably remain uncompetitive. Peripheral Member States lag behind the stronger economies of the union because "they are stuck at middle levels of technology and they are caught in a trap. Reducing wages would not solve the problem"

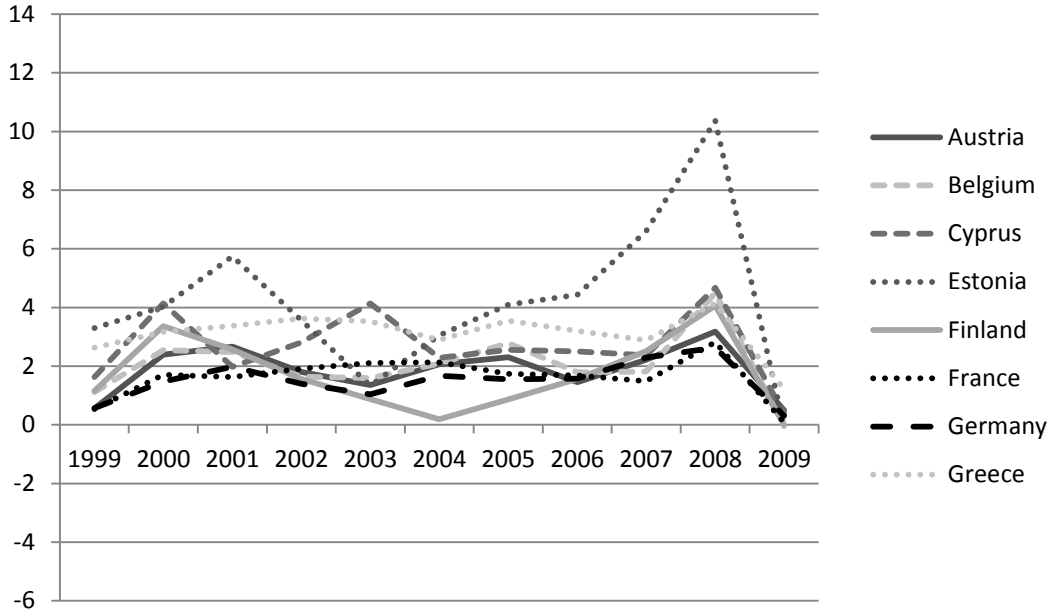
(Felipe, Jesus and Kumar 2011). When taking into account the price deflator of every country, with the exception of Greece, every country's ULC's actually decreased or remained constant. Felipe and Kumar (2011) also introduced the idea of unit capital costs, which account for expenses incurred by firms outside of labor. They found that those costs increased at a faster rate than ULC's throughout the euro area.

Felipe and Kumar (2011) weighed three options they believed were available to the economic periphery of the Eurozone. One course of action was austerity and structural reforms dedicated to the reduction of ULC's and unit capital costs. The second option was exiting the euro area altogether and devaluing the national currency to achieve greater competitiveness. The third and final option, which they endorsed, was to allow for Member States to use more "active fiscal policy" (which they did not elaborate on) and combine that with an effort towards upgrading the export market to make it resemble Germany's (Felipe, Jesus and Kumar 2011).

Although, the highly indebted countries of the euro area tend to have much higher ULC's, Felipe and Kumar (2011) presented a valid argument on the deceptiveness of that indicator. European institutions place a lot of value on aggregate economic data, but fail to account for the nuances that contribute to those statistics. That seemingly inherent shortfall of the central bureaucratic apparatus of the Eurozone serves as a reminder that maximizing the strength and competitiveness of the Eurozone periphery should remain under the purview of national leaders.

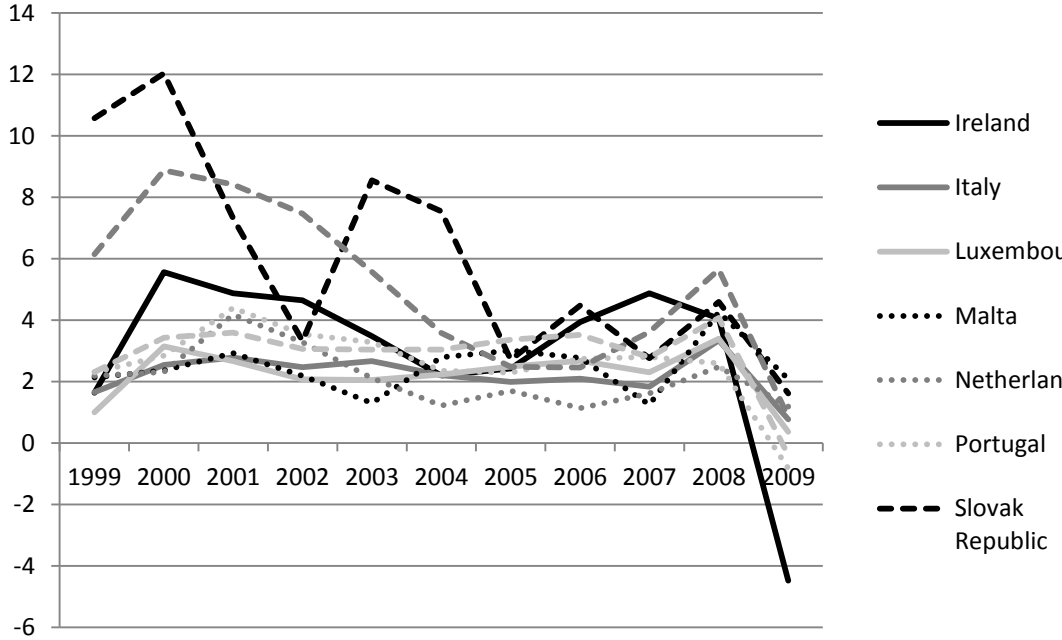
Scheremet (2000) doubted that convergence on inflation rates would be enough to ensure a successful monetary union (See figures 5.1 and 5.2). Lack of convergence of unemployment could possibly pose a long-term threat on the Eurozone as well. He

Figure 5.1: Eurozone Consumer Price Inflation Rates (A-G)



Source: World Bank Statistics

Figure 5.2: Eurozone Consumer Price Inflation Rates (I-S)



Source: World Bank Statistics

explained that "labour markets grow apart in the case of a new negative supply-side shock, demands for transfers would surely materialize, and political instabilities could appear within monetary union" (Scheremet, Wolfgang 2000). He suggested that similar labor market flexibility throughout the euro area would eventually lead to convergence of unemployment rates. Scheremet (2000) broadly defined labor market flexibility as covering policy areas such as "taxation, and social insurance systems, labour law, the institutional organization of the wage determination process and its ability to adjust to cyclical and structural changes" (Scheremet, Wolfgang 2000). Treatment for the effects of asymmetric shocks would require labor mobility, fiscal policy or relative wage flexibility. Diverging structural dynamics pose a greater threat to convergence than violation of fiscal rules. Flawed wage and labor structures also aggravate economic hardships for countries experiencing recession.

In an optimum currency area (OCA), countries "with high divergence in output and employment trends need a lot of flexibility in their labour markets if they want to form a monetary union, and if they wish to avoid major adjustment problems" (de Grauwe, Paul 1996). The more divergence of output and employment, the more flexibility is necessary in labor markets for the currency union to function. De Grauwe (1996) observed that the euro area did not exhibit the features of an OCA. However, "there is a subset of EU-countries which form an optimum currency area" (de Grauwe, Paul 1996). As a result, he recommended a "two-speed approach" to monetary unification in which a small group of countries would enter the Eurozone first, while giving other countries more time to adjust before joining. Leaders of the Member States, however, decided that all prospective members should join simultaneously. Some of the causes for

the sovereign debt crisis would reveal the mistake they made in rushing to adopt the euro. Moreover, the agreements leading up to EMU did little to solidify the union as an OCA.

Optimum currency theory assigns little importance to convergence on inflation and budgetary matters. Countries with diverging inflation rates and fiscal policies could be less prone to asymmetric shock because of similar economic structures. Conversely, states may have similar inflation levels and similar amounts of public spending, but experience shocks that are asymmetric because of divergent fiscal and monetary structures. For example, if one were to compare Belgium and Germany, one would find that,

> Belgium certainly satisfies the inflation convergence criterion. At the same time, however, Belgium has a full wage indexing system, whereas Germany does not have one. As a result, when an oil price shock occurs [within the Eurozone], the wage price spiral in Belgium is likely to lead to competitiveness problems of the Belgian industry (de Grauwe, Paul 1996).

The fact that a country was able to control its levels of inflation or public expenditures does not mean that it is well equipped to avoid a future asymmetric shock. De Grauwe (1996) believed that without "some degree of centralization of national budgets," fiscal constraints would likely do more harm to the union and deprive countries of their only viable tool to combat an asymmetric shock. Once again, the rigid fiscal rules of the SGP may have done more to hinder economic stability and convergence.

Garret and Way (1995) explained that countries with unionization in sectors exposed to international market competition would be able to adjust well to membership in the Eurozone. Those unions were able to exercise wage restraint in the years leading up to monetary union because of foreign competition for labor. Countries with strong public sector unions, however, may also have had an incentive to join EMU because "A

government might join a fixed exchange rate regime precisely to tie its hands to prevent itself from expanding the public economy" (Eichengreen, Barry J. 1995). Garret and Way (1995) also explained that states with fiscal imbalances tended to value accession to the EU and other transnational European arrangements as a solution to their credibility issues. Garret and Way (1995) observed, however, that the European Monetary System (EMS) revealed discouraging evidence to the contrary. They were also skeptical about the ability of monetary union to rectify those issues in the future.

Delbecque and Larèche-Révil (2007) found that employment protection legislation (EPL) reduced foreign direct investment (FDI) because it "prevents firms to adjust freely to product market condition." They also found no evidence of productivity increases resulting from unionization (Delbecque, Vincent and Larèche-Révil 2007). Barell (2008) explained that structural reforms in domestic labor markets are necessary to increase FDI and GDP growth. Therefore, insufficient labor market reform contributes to the major competitiveness issues peripheral Member States face.

Duval and Elmeskov (2006) found that while EMU sates were more active in their labor and product markets relative to other OECD countries, they lagged behind EU states that remained outside of the currency union. Furthermore, they found little evidence that such structural reforms had anything to do with membership in the euro area because they observed a deceleration in reforming those sectors of their economies (Duval, Romain and Elmeskov 2006). One impediment to labor market reform is that the economic benefits of such disinflationary and competitiveness-enhancing reforms manifest themselves slowly in larger countries (Giavazzi, Francesco and Spaventa 2010).

Slow manifestation of the positive effects of labor market reforms could also make political actors in larger countries more reticent to initiate those reforms.

Bertola and Boeri (2002) found that economic integration may even aggravate unemployment "or at least make it more urgent for economic agents to exploit all margins of flexibility left open by institutions that reduce employment rates." Domestic reforms concerning employment and wage formation take time and thus cannot address the problem immediately. Furthermore, labor reforms do not point completely in one direction. Usually, legislation reducing wage and social benefits for labor may be "bundled together with measures compensating specific groups" (Bertola, Giuseppe and Boeri 2002). In fact, reforms enacted one year are sometimes undone the following year.

Although labor reforms progress at a slow and uneven pace, Member States should retain autonomy on those policies regardless. If their failure to enact or maintain labor reforms creates domestic fiscal problems, the Eurozone should grant Member States the same autonomy and flexibility under those circumstances as well while allowing for the possibility of default. Federalism is a two-way street. States should be able to benefit from policy autonomy, but should internalize the potential failures of those policies as well.

Economic Risks and Rewards of Monetary Union:

Monetary union reduced exchange rate volatility among states in the euro area and reduced volatility for states outside of it as well; Sweden and Denmark being the

primary examples, as they have fixed their exchange rates to the euro (Barrell, Ray. 2008). Faruqee (2004) found that exchange rate certainty moderately contributed to increasing trade in within the euro area. EMU contributed to accelerating trade between Member States and non-members as well. However, there is wide dispersion with the Member States that have benefitted from the trade effects of monetary union. In fact, "some countries have been (and remain) better positioned to reap the trade benefits from the single currency, and these differences do not appear to be narrowing" (Faruqee, Hamid 2004). Faruqee (2004) also found that product market reforms and changing trade patterns had a greater influence on the trade effects of monetary union than exchange rate certainty.

The UK, however, which continued to pursue an independent monetary policy in spite of its close trade relationship with the Eurozone is "likely to have experienced an increase in the volatility of the real effective exchange rate as a result of EMU" (Barrell, Ray 2008). Viñals and Jimeno (1998) also explained that financial and monetary shocks, which were the result of "imperfectly coordinated national monetary policies, currency substitution, and exchange rate movements," would no longer exist under EMU and the single monetary policy.

EMU creates greater price stability by controlling long-term inflation, "thereby exerting a moderating influence on price and wage-setting behaviour" (Barrell, Ray 2008). Furthermore, "To the extent that the introduction of the euro and the implementation of the Single Market Programme removed trade barriers and increased transparency, they may have impacted output and productivity growth directly" (Barrell, Ray 2008). Exchange rate volatility among the geographically proximate states of Europe

led to the exchange rate crisis of 1990. Single monetary policy under EMU eliminated any future likelihood of such destabilizing exchange rate policy in the euro area (Barrell, Ray 2008).

When comparing the US and EU, Viñals and Jimeno (1998) found that "idiosyncratic shocks [tended] to be more frequent in the EU than in the United States." They also found that "shocks are more similar between the US and the subset of EU countries that have traditionally maintained closer economic and monetary links with Germany" (Viñals, Jose and Jimeno, 37). That finding led them to extrapolate that a smaller and more integrated EMU would avoid the risks of asymmetric shock, while a larger Eurozone would not be able to. That conclusion seemed to favor the de Grauwe (1996) prescription for a two-speed approach to union.

Barrell (2008) concluded that monetary union had direct effects on output growth "and also promotes reductions in output and real effective exchange rate volatility and thereby influences the accumulation of productive capital." He also found that EMU has had a net positive effect on economic growth and employment. However, since the birth of the common currency, economic growth in the euro area lagged behind the US, UK, Denmark, and Sweden (Barrell, Ray 2008).

De Grauwe (2011) explained that when a country issues debt in a currency it has no control over, it becomes more susceptible to default through deflation. When bondholders sell their holdings in a Member State's debt and use their euros to invest in another Member State, one country gains liquidity at the expense of another. Consequently, the country losing liquidity risks experiencing deflation. Deflation, in addition to high interest rates, makes debt repayment more difficult. When a country has

control of its currency, however, bondholders can choose to sell their holdings, but are paid in the currency directly issued by the country. As a result, that money would inevitably find its way back to the bond issuing country and keep money supply unchanged. If the money was not reinvested in the debtor nation, its central bank would monetize its debt and avoid default (de Grauwe, Paul 2011). The problem with the de Grauwe (2011) argument, however, is that inflation rates converge under monetary union and are therefore less likely to be a factor in making debt repayment more difficult for certain Member States.

There are several shortcomings that arise from losing control of monetary policy. Eurozone countries lose the ability to reduce the real value of debt through inflation. Another limitation of EMU is that although there may be a single central bank issuing the currency, there is very little homogenization of banking regulation among the Member States. In an environment "where banking regulation and supervision are also centralised and therefore cross-border banking issues are not relevant, fixing the financial system is certainly easier" (Darvas, Zsolt 2010).

Mankiw (2010) explained that the Eurozone resembles the American monetary union of the 19th century, where the federal government was relatively small and states had completely autonomous fiscal policies. The 19th century US currency union worked well in spite of the shocks it endured because it had labor mobility; therefore exhibiting the characteristics of an OCA. The problem with the euro is that there is little to no labor mobility because language and cultural differences among European countries are far greater than they ever were among US states (Mankiw, Gregory 2010).

Although the sovereign debt crisis in the Eurozone resembles the crises among several US states, the Eurozone crisis has attracted more fear in spite of the fact that combined debt in the Eurozone is lower than that of the US federal government—however, the individual US states have less combined debt than the Eurozone. The Greek fiscal situation is also much worse than it is in any of the US states. Fear of widespread contagion from Greek default within the Eurozone threatens to destabilize the monetary union. European bank holding of peripheral debt could become a source of instability if Member States opt for default.

An additional problem with the Eurozone debt crisis is that the policy response among European institutions and leaders has been ambiguous and disorganized. For example,

> When the Greek crisis began to intensify in February 2010, the Greek government was hesitant about adopting further consolidation measures, and European partners dithered over making a loan to Greece and agreeing to IMF involvement (which, by the way, is not prohibited by any EU regulation). As the crisis intensified, policymakers started to blame 'speculation', or suggest ad hoc measures, such as banning certain financial products and setting up a European credit rating agency. When policymakers are busy with these kinds of redundant activities and provide conflicting signals about their intentions, markets are likely to draw the conclusion that policymakers do not have the means to resolve the crisis (Darvas, Zsolt 2010).

Krugman (2010) also observed that even though many US states face fiscal turmoil as well, residents of those states continue to receive Social Security and Medicare checks from the federal government regardless of how much states consolidate their budgets. In the Eurozone, however, citizens are dependent on the Member State—not a transnational bureaucracy—for social services (Krugman, Paul 2010). US citizens simply do not endure the same consequences of their state's economic troubles as citizens of individual Eurozone countries.

The immediacy of Member State fiscal crises, however, also provides a more direct market response to bad economic policies and perpetuates the necessity for more substantive reform. Blurring market signals by establishing a larger and more active central government merely transfers the problem without eliminating it. The US federal government currently faces a heavy debt burden due, in large part, to its obligations to pay Social Security and Medicare. Transferring any economic and political responsibility of fiscal policy to a transnational bureaucratic apparatus does nothing to mitigate the problem of excessive debt accumulation.

Causes of the Sovereign Debt Crisis:

Matei (2010) explained that the rise in housing prices created rising wages, which made real estate more affordable. As a result of higher labor costs, exports became more expensive, which fed into large current account deficits in Spain and Ireland. When the European sovereign debt crisis started to develop in late 2009, four euro area countries became the symbols of Europe's fiscal mismanagement: Portugal, Ireland, Greece and Spain (colloquially referred to as the "PIGS"). Greece was the only Member State that spent recklessly and actively distorted and suppressed important macroeconomic data in the years leading up to the financial crisis.

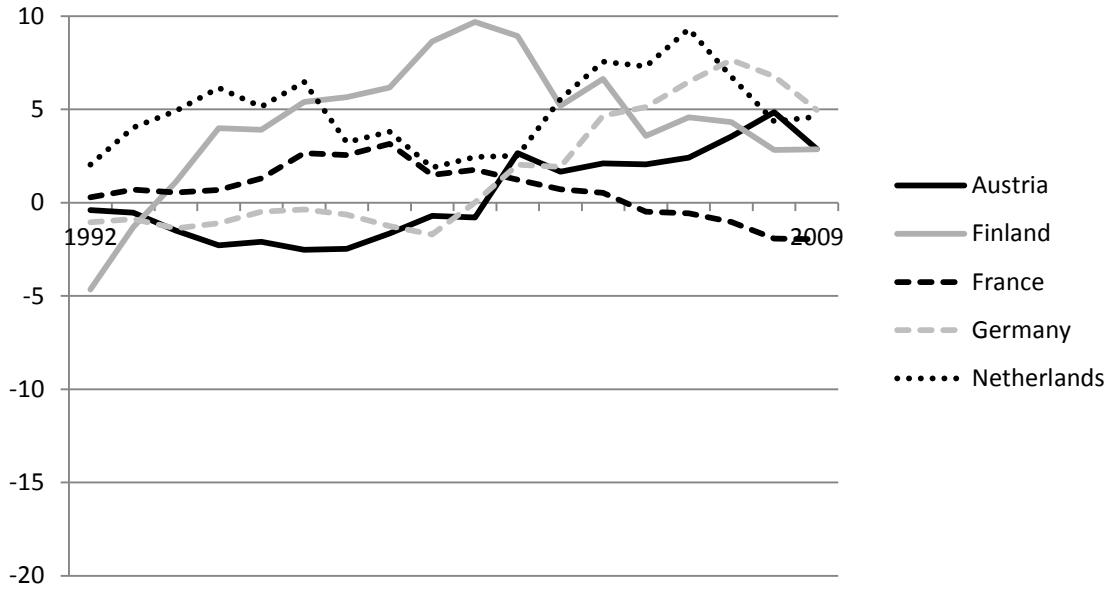
During the years preceding the global recession, Portugal, Spain and Ireland were paradigms of the Eurozone's success. They were enjoying healthy economic growth, relatively disciplined fiscal policies with low deficits (and surpluses in the case of Ireland

and Spain). However, Giavazzi and Spaventa (2010) noted that many seemingly reliable indicators of economic health insufficiently explained the economic realities within those countries in the years leading up to the financial crisis. The illusion of economic health vanished soon after the fall of 2008, and what emerged were the high levels of foreign debt they accumulated from current account deficits and household debt (See figures 6.1 and 6.2). Although the data was available to European officials, they saw the imbalances as a positive by-product of convergence. Today, however, "they came to be considered as symptoms of future sovereign insolvency and indicators of the inherent fragility of the whole single currency project" (Giavazzi, Francesco and Spaventa 2010).

Although monetary union may have mitigated the short-term pressures of high current account deficits and household debts, inflation targeting was clearly an insufficient tool for preventing excessive credit growth in Spain and Ireland (Giavazzi, Francesco and Spaventa 2010). Furthermore, Giavazzi and Spaventa (2010) noted that there was little consideration for the distinction between "productive and unproductive purposes of foreign borrowing" in the case of the smaller/weaker economies within EMU. Heavy foreign borrowing and the GDP growth that accompanied it in the catch-up countries of the euro area had to be repaid eventually. The only way to service that debt was through the growth of their "productive capacity of exportable goods and services" (Giavazzi, Francesco and Spaventa 2010). The force behind of GDP growth in southern Europe and Ireland was the expansion of the housing sector, which was an inherently non-exportable good. Giavazzi and Spaventa (2010) explained that such a distinction never made its way to the traditional convergence models describing EMU dynamics.

In addition, "the output of construction in housing services - is a largely non

Figure 6.1: Current Account Balance % GDP (AAA Rated Eurozone Countries)



Source: World Bank Statistics

Figure 6.2: Current Account Balance % GDP (PIGS Countries)

Source: World Bank Statistics

traded good. Selling houses to foreigners would be registered as foreign direct investment: but direct investment was a small share of total flows" (Giavazzi, Francesco and Spaventa 2010). Convergence models also aggregated all goods in a country as tradable without considering that some goods may not have the same tradability as others. Once they accounted for that distinction, Giavazzi and Spaventa (2010) found that the current account deficit became more significant than the traditional convergence models had assumed (Giavazzi, Francesco and Spaventa 2010).

What compounded the problem of excessive credit growth in a sector of non-tradable and non-exportable goods was that foreign investors did not withhold capital in the face of an increasingly apparent housing bubble. The reason investors continued to flood capital was because they were lending to domestic banking institutions that executed the loans going towards construction (Giavazzi, Francesco and Spaventa 2010). Thus investors were unaware of the fact that they were indirectly feeding into the housing bubbles in Spain and Ireland. For some reason, current account deficits seemed to have a greater effect on the workings of the euro area while remaining irrelevant within the individual states of the US.

Giavazzi and Spaventa (2010) explained that the inability to distinguish between traded and non-traded goods was not an adequate explanation for the different effect it had in the euro area relative to the US. They found that the reason the current account deficit was more significant within EMU than it was in the US was that markets differentiated the debts of American states and the debts of Member States of the common currency. Investors seemed to be more preoccupied with the location of a corporation in Europe than they were with the location of a corporation within the US. In

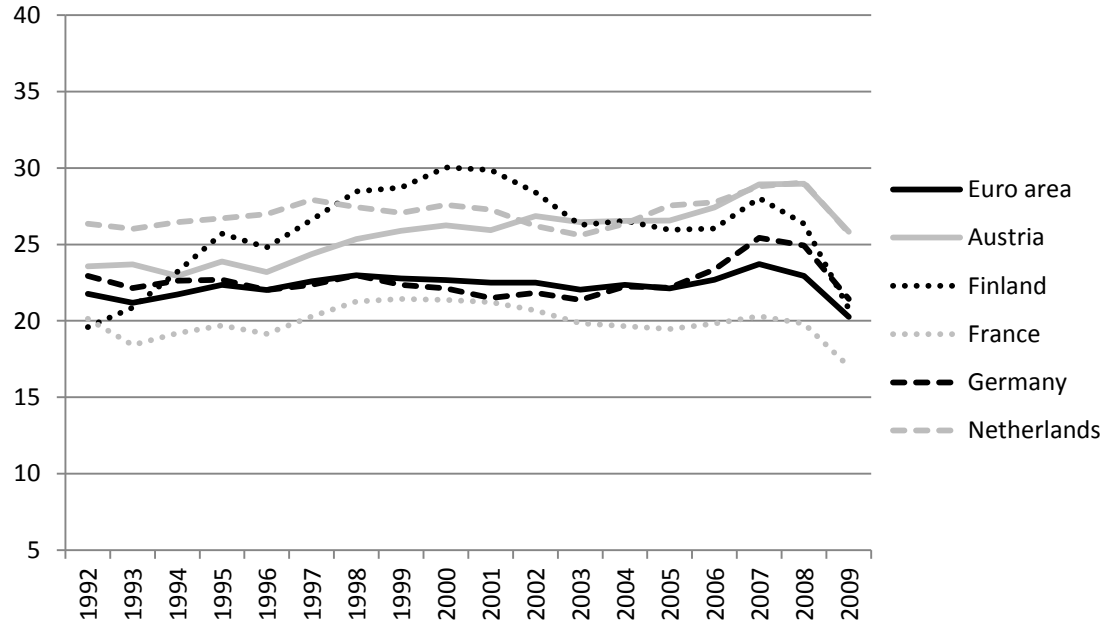
addition, "there is far greater personal mobility within the US than within Europe, where there are language barriers and administrative obstacles: this by itself reduces the quantity of goods and services which are traded in the sense that they are consumed at home by non-residents" (Giavazzi, Francesco and Spaventa 2010).

Another distinguishing trait Giavazzi and Spaventa (2010) observed was that the US was a federation, whereas Europe exhibited the characteristics of "an association of fully sovereign states which, even when accepting a common currency, have delegated their competences to Union law only in some specific matters: not for the national budgets (the Union budget being almost non-existent), not for taxation, not for civil and company laws, not for bankruptcy laws" (Giavazzi, Francesco and Spaventa 2010). Even when European laws were applicable, they were bereft of requirements and had yet to address the financial services sector, which remained under the purview of national governments. Member States seemed to operate more autonomously than American states. As a result, "a common currency, while blurring to some extent the notion of a Member State's foreign position, is not by itself sufficient to make that notion irrelevant" (Giavazzi, Francesco and Spaventa 2010).

Ireland and Spain led the Eurozone in construction investment "both as a ratio to GDP and as a share of total investment," which indicated a dependence on the housing industry (Giavazzi, Francesco and Spaventa 2010). Ireland and Spain also had significant increases in investment and decreased savings rates (See figures 7.1 and 7.2). Portugal also experienced a fall in its savings rate "in spite of a decline in the investment rate."[9] As a result of the housing boom in Ireland and Spain, domestic credit increased. "Between

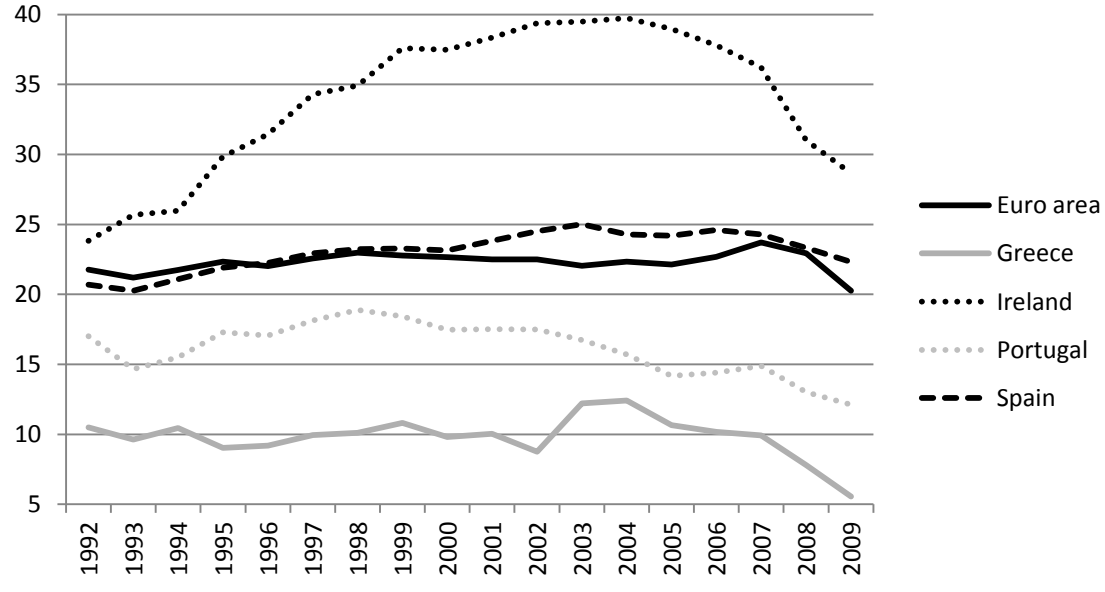
[9] Greece's savings numbers are still under revision

Figure 7.1: Gross Domestic Savings % GDP (AAA Rated Eurozone Countries)



Source: World Bank Statistics

Figure 7.2: Gross Domestic Savings % GDP (PIGS Countries)



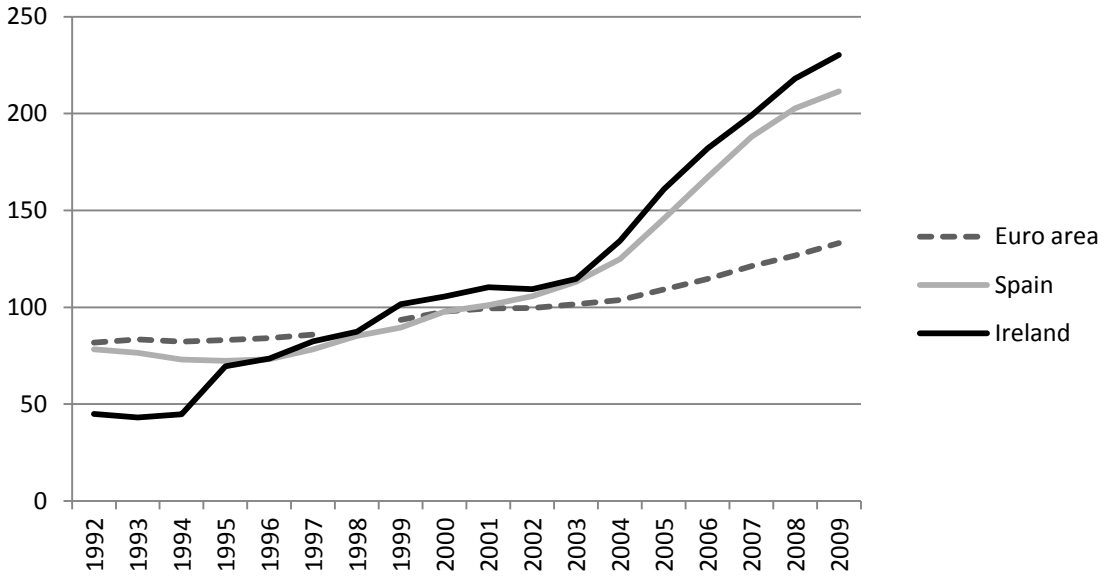
Source: World Bank Statistics

2004 and 2007 loans for housing credit increased by 68 percent in Ireland and by 65 per cent, in Spain," which was double the Eurozone average (See figure 8). Foreign borrowing was the main source of credit growth "as domestic banks would tap the interbank market and issue commercial paper or bonds (Kelly 2010, Suarez 2010)" (Giavazzi, Francesco and Spaventa 2010).

A major contributor to the heavy foreign borrowing within the Eurozone periphery was that yields on sovereign debts throughout the entire euro area remained low. Leading up to the global financial crisis, there was a perception of low risk and vast amounts of global liquidity. Markets also perceived that adoption of the euro would improve the growth prospects of the monetary union's economic periphery. In addition, they also recognized that there was no mechanism within any of the relevant treaties that made the no-bailout clause credible. All of those factors contributed to artificially low borrowing costs throughout the economic periphery of the monetary union (Arghyrou, Michael and Kontonikas 2011).

Giavazzi and Spaventa (2010) claimed that monetary union provided the perfect breeding ground for a credit boom in the Eurozone periphery. It eliminated "currency and liquidity risks (and by fostering financial integration), EMU represented a major shock for those countries, as even low yield differentials would attract massive capital flows. But this is, after all, what the convergence model would predict" (Giavazzi, Francesco and Spaventa 2010). By setting short-term real bank market interest rates at negative levels, ECB monetary policy fueled the real estate bubble in Spain and Ireland; countries where real interest rates were much higher prior to adoption of the euro. With the adoption of the Euro, interest rates went from 4.5% and 5.5% in Spain and Ireland

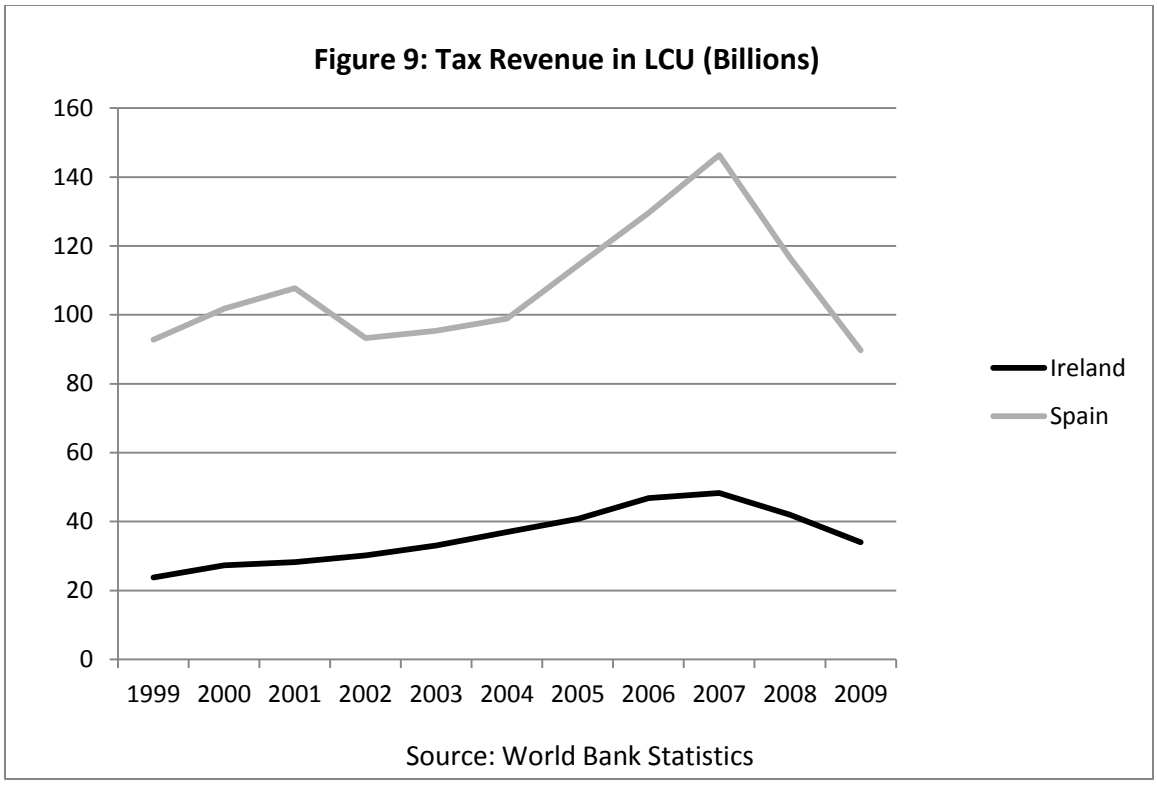
Figure 8: Domestic Private Sector Credit (% of GDP)



Source: World Bank Statistics

respectively to under 1% (Eichengreen, Barry J. 2009). "Once the housing bubble burst and capital inflows to finance current account deficits dried up, very serious economic and financial difficulties eventuated" (Eichengreen, Barry J. 2009).

Although Spain's fiscal house seemed to be in order, the structural deficit was increasing. The housing boom distorted tax collection data because "the incomes indirectly generated as a result of the vitality of construction, the strength of job creation, the artificially low unemployment rate, the apparent rise in household wealth due to the increase in real estate prices, and the parallel consumption boom" made economic outlook in Spain seem more optimistic than it really was (Suarez, Javier 2010). The bursting of the housing bubble put pressure on the fiscal positions of Spain and Ireland—especially since their tax revenues were heavily dependent on growth in the housing sector. With the exception of Cyprus, Spain and Ireland experienced the largest percentage drop in tax revenue from 2008 to 2009 (See figure 9).



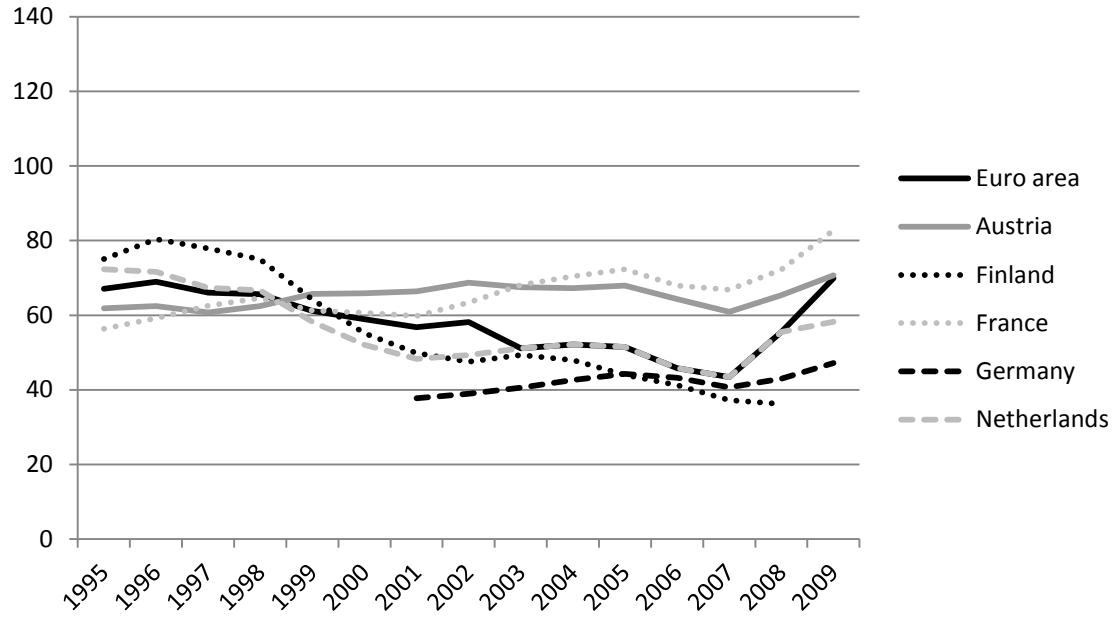
Due to the boom in the housing industry and growing corporate profits, Ireland was able to offer workers higher wages. The domestic boom masked the unemployment effects of exceedingly high labor costs and the damage they did to international competitiveness. Although part of Ireland's fiscal crisis originated in rising spending (as a share of GDP) after 2004, the main cause was its precipitous decrease in revenue (Honohan, Patrick 2009). Honohan (2009) explained that the drop in tax revenue was a result of a tax structure that was overly reliant on "cyclically sensitive taxes," including the "corporation tax, stamp duties and capital gains tax (in that order). Their share of tax revenues peaked to 30% in 2006 until eventually tumbling to 20% at the downturn during 2008" (Honohan, Patrick 2009). Even though corporate taxes were low (12.5% in 2009), their attractiveness to foreign firms brought tax revenues to the high levels the Irish government enjoyed leading up to the financial crisis.

Under the cover of high corporate tax revenues, the Irish government used the appeal of lower income tax rates as a strategy for getting workers to moderate their wage demands. The Irish government was able to afford its concessions on income taxes because of their increasing revenues from other sources. Although total tax revenue in 2008 fell by 14%, the revenue decrease from "cyclically sensitive" taxes was even greater at 36%. In addition, spending increased 11% in 2007 and 2008 respectively, which aggravated the fiscal problems Ireland was starting to experience (Honohan, Patrick 2009).

While the source of Spain and Ireland's troubles originated in an overheating of the housing industry, construction in Greece and Portugal declined while remaining stable throughout the rest of the Eurozone. Excess production of non-tradable goods was not a major issue in Greece or Portugal and private investment to GDP was roughly equal to the Eurozone average. Greece simply had too much consumption and exorbitant public deficits, which culminated in its 10-year sovereign bond notes exceeding interest rates of 450 basis points[10], which made its debt unsustainable (Paliouras, Vaileios). Portugal had similar issues, but was in worse shape because its economy was stagnant during the first several years of monetary union (Giavazzi, Francesco and Spaventa2010. In order for Greece to return to a manageable debt of 60% of GDP (See figures 10.1 and 10.2) in twenty years, they would need a surplus of 8.4% of GDP. That ambitious target means 20-25% of Greek tax revenues would have to go toward paying interest on its debt. The only OECD country to maintain a surplus of over 6% over the past 50 years was oil rich Norway. "Even less ambitious targets would require politically unrealistic surpluses" (Sapir, Andre, Pisani-Ferry and Darvas 2011)

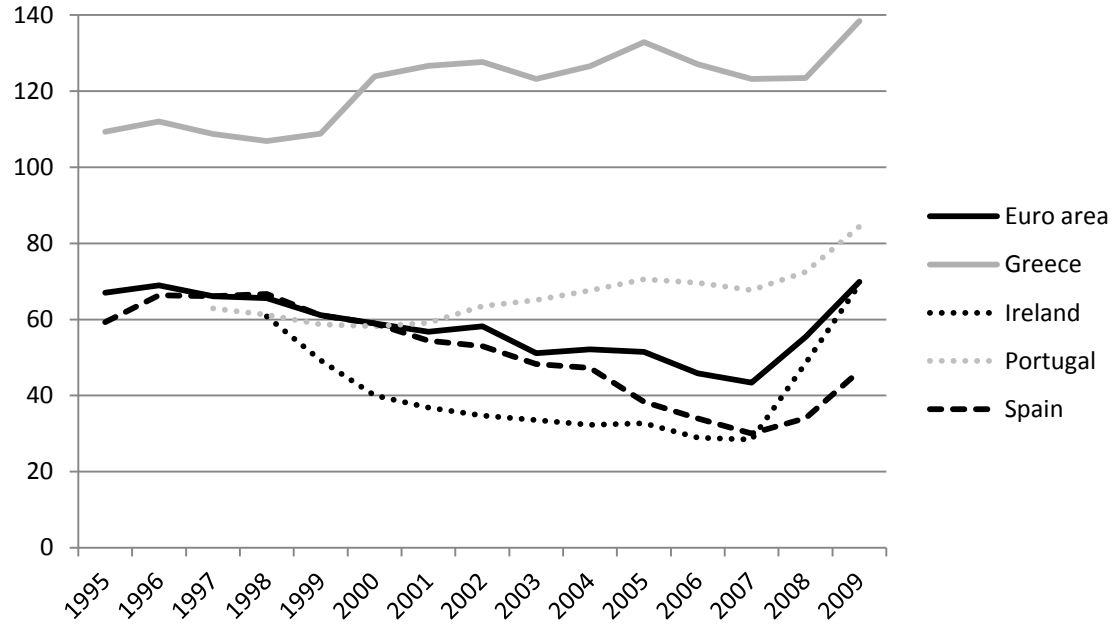
[10] One "basis point" means .01%

Figure 10.1: Debt as % of GDP (AAA Rated Eurozone Countries)



Source: World Bank Statistics

Figure 10.2: Debt as % of GDP (PIGS Countries)



Source: World Bank Statistics

Darvas (2011) found that the spillover effect from a "sustainability-restoring haircut" on debt of the Eurozone periphery would have a moderate effect on banks and have a limited effect on the rest of the economies in the Eurozone. Banks in the Eurozone also have relatively little exposure to Irish or Portuguese sovereign debt. Only Spain has both heavy bank exposure to sovereign debt and a sovereign debt crisis of its own (Sapir, Andre, Pisani-Ferry and Darvas 2011). In addition to the fact that investors became more selective about the sovereign bonds they invested in during the aftermath of the financial crisis, the lack of a national central bank to "support the national Treasury as 'market maker of last resort'" left the more aggrieved Eurozone countries economically stranded.

Giavazzi and Spaventa (2010) observed that while the economic benchmarks of the SGP were important, they were superficial and should have contained requirements pertaining to "relative productivity and cost trends; credit and leverage; the savings-investment balance, and hence the current account, which, though no longer a short-term binding constraint under a common currency, is an immediate indicator of the existence of output-expenditure imbalances" (Giavazzi, Francesco and Spaventa 2010). Inflation and interest rate convergence is a much less useful indicator of integration when considering that they naturally converge to a great degree under monetary union anyway.[11] Another problem was that the SGP outlined ineffective institutional measures to address its fiscal problems. Although there was some convergence in terms of SGP benchmarks, there was increasing divergence in the variables Giavazzi and Spaventa (2010) mentioned. For example, the ostensible successes in Spanish and Irish management of its debts and deficits were mitigated by later developments. They

[11] Figures 5.1 and 5.2 on page 37 confirm that inflation has gradually converged within the euro area, even as the debt crisis was unfolding.

concluded that “the stability of the monetary union [must depend] on a wider set of conditions than compliance with budgetary discipline” (Giavazzi, Francesco and Spaventa 2010).

As a panacea for the deficiencies of the SGP, Giavazzi and Spaventa (2010) suggested imposing a ceiling on domestic credit accumulation. They admitted, however, that such a ceiling would be difficult to establish through common monetary policy; mainly because it is incapable of dealing with “divergent credit dynamics within the union” (Giavazzi, Francesco 2010). Centralizing the union under common economic benchmarks is simply too complex. Instead, they suggested creating “supervisory and regulatory powers” that impose stricter lending requirements. National regimes were also insufficient to curb the excesses that led to the problems Europe experienced after the financial crisis. The ECB does not have any of the requisite powers either. Instead, Giavazzi and Spaventa (2010) had more confidence in the European Systemic Risk Board (ESRB), which came to existence after the 2009 de Larosière report recommended the establishment of a supervisory body to oversee risk in the financial system throughout the EU (Eurpean Systemic Risk Board).

The fiscal crises in southern Europe and Ireland show that not all sovereign debt is created equal. While fiscal profligacy ultimately was responsible for the problems in Portugal and Greece, more obscure variables contributed to the crises in Ireland and Spain. Furthermore, the consensus is that SGP rules did not have enough credibility to deter the Greek and Portuguese governments from spending beyond their means. Procyclical fiscal policies further fueled the overheating of the housing market and using monetary policy as a means of cooling it was out of the question. With different Member

States came different economic structures. The one-size-fits-all structure of monetary union constrained the ECB from addressing the illicit growth of the housing industry in Spain and Ireland.

At first glance, the difficulties of a one-size-fits-all monetary policy may lead countries to pull out of the arrangement. There is some temptation because independent monetary policy would allow for a state to devalue its currency in an effort to boost exports or provide for a sovereign bond purchaser to act when government bond auctions fail (Eichengreen, Barry J. 2009). However, the argument for currency devaluation as a means of boosting the strength of exports rests on the popular J-curve theory[12], which has little empirical support (Rose, Andrew K. 1989). Moreover, the devaluation that occurs as a result of excessive bond purchasing on the part of central banks can undermine price stability through inflation. Instead, economically troubled Member States should focus more on structural changes in order to become fiscally disciplined and internationally competitive.

Eichengreen (2009) conceded that there were attractive features to reverting to national currencies, but he quickly dismissed such a course of action as unworkable and potentially disastrous. First, currency depreciation or support for "embattled domestic producers with concessional loans and subsidies" on the part of the exiting country would create political tensions within the EU. That development would "threaten Europe's signal economic achievement, the creation of a true single market in which producers in EU countries compete on an equal footing. More complaints of currency manipulation and competitive devaluation would place this achievement at risk" (Eichengreen, Barry J.

[12] The theory that a given country's exports become cheaper and consequently more attractive when its currency loses value. Therefore, the implication is that trade deficits go down as well.

2009).

The Lisbon Treaty contained an exit clause allowing withdrawal from the EU, but contained no clause allowing for an exit from the euro. "The implication is that in order to quit the euro a country would have to quit the EU, thereby abrogating the entire range of treaty obligations to its fellow member states" (Eichengreen, Barry J. 2009). The reintroduction of national currencies may even have the opposite effect that national governments would desire because bond spreads have risen to higher levels among some European countries that are outside of the Eurozone (Eichengreen, Barry J. 2009).

Eichengreen (2009) found that investors and rating agencies are attracted to Member states' sovereign bonds because of the rules and sanctions of the SGP. Moreover, the no-bailout clause prevented the ECB from purchasing treasury bonds directly from national governments (Eichengreen, Barry J. 2009). In May of 2010, however, the ECB initiated its sovereign debt purchase program called the "Securities Market Programme" in the Eurozone periphery, which continues to the present day (Sapir, Andre, Pisani-Ferry and Darvas 2011).

There are other impediments that would persist in the event of a withdrawal the euro. Even if "wages and other incomes [were] redenominated into that national currency, it would become necessary to redenominate mortgages and credit-card debts of residents as well" (Eichengreen, Barry J. 2009). If not, depreciation of the national currency "would have adverse balance-sheet effects for households, leading to financial distress and bankruptcies" (Eichengreen, Barry J. 2009). With the redenomination of mortgages and other bank assets, "bank deposits and other bank balance sheet items would have to be redenominated in order to avoid destabilizing the financial sector"

(Eichengreen, Barry J. 2009). The redenomination of government revenues in national currency "not just public-sector wages and pensions but also other government liabilities, notably the public debt, would have to be redenominated to prevent balance-sheet effects from damaging the government's financial position" (Eichengreen, Barry J. 2009).

Another problem with currency redenomination that would result from abandoning the common currency would be that foreign investors could still demand compensation in euros under "continuity of contract provisions." Therefore, leaving the Eurozone would not resolve a country's sovereign debt problems. If a withdrawing country chose to redenominate its debts, it would have less access to international financial markets and currency depreciation would increase the price of sovereign debt (Eichengreen, Barry J. 2009).

Historically, breakups in monetary unions took place when members "were relatively closed to trade and financial flows and when the banking and financial system was underdeveloped or tightly regulated, leaving only limited scope for capital flight when preparations were underway" (Eichengreen, Barry J. 2009). Nitsch (2004) also confirmed that currency unions are more likely to break up when members have closed economies. Considering that one of the essential characteristics of the euro area is its economic openness, EMU does not fit that description. The Nitsch (2004) study also found that breakup is more likely when there are large differences in GDP per-capita among member states, high inflation differentials, low trade (as a share of GDP). Interestingly, differentials in current account balances, symmetry of shocks, or fiscal issues have no predictive effect on the survival or failure of currency unions (Nitsch, Volker 2004).

In light of the Nitsch (2004) findings, greater oversight on the current account position of Eurozone countries, as Giavazzi and Spaventa (2010) suggested, is no longer necessary. Furthermore, additional institutionalization through the ESRB and other similar European structures is unnecessary. The Nitsch (2004) findings serve as additional confirmation that there is no necessity for increasing centralization and bureaucratization of the currency union in order to address some of the economic issues it faces.

Bordo and Jonung (1999) analyzed the survival of monetary unions based on whether they exhibited national or transnational characteristics. They found that monetary unions that are politically united have distinct outcomes than those that are not. Transnational monetary unions were much easier to break up if the states within the arrangement retained their central banks during the period of monetary union. They concluded that fraying of political unity within the monetary union is ultimately what is responsible for the breakup of a monetary union. Economic disagreements remain important as well. The US Civil War and the breakup of Czechoslovakia are evidence of how diverging economic views caused the breakup of those monetary arrangements.

The problem with examining EMU is that it has the features of a transnational currency union, while retaining other features that make it a politically unified, national currency union—even though there is no central fiscal apparatus at the European level. Bordo and Jonung (1999) found that EMU had a more proximate resemblance to a national currency union because it has a singular monetary authority (the ECB), permanent membership, and no escape clauses built into the framework. The essential

trait of a national currency union is that political—not economic—considerations are the strongest determinants of their creation and their dissolution (Bordo, Michael D. 1999).

One of the difficulties with evaluating the possible solutions for the issues afflicting EMU is adequately defining what kind of a union the euro area is. In one way the euro area resembles the loose federation that Giavazzi and Spaventa (2010) described. However, it also has qualities that resemble a national currency union (e.g. the US). This thesis argues that it is somewhat of a hybrid and it accepts that investors do make distinctions between European debts and American debts. However, as Bordo and Jonung (1999) explained, there are too many features of EMU that resemble a national currency union.

Eichengreen (2009) believed that EMU would either have to go in the direction of more centralized control of financial markets within European level institutions "in a manner analogous to the relations between the ECB and euro area national central banks or it will have to move backward to the renationalization of its financial markets" (Eichengreen, Barry J. 2009). After Member States put so much effort into the Euro, Eichengreen (2009) envisioned a trend towards greater transnational bureaucratization.

In light of Eichengreen's own analysis on the disastrous effects of withdrawal, he may have overlooked the possibility that the necessary corrective measures may actually follow from the institutional failures of the Eurozone. If the costs of default within the union are outweighed by the costs of defaulting or inflating outside of it, the domestic political environment necessary to enact substantive economic reforms would finally emerge, whereby highly indebted states could opt for default and ultimately strengthen the long term viability of the monetary union.

Centralization of EMU policy would be difficult considering that EU budget only comprises 1% of European GDP and remains limited to specific policies such as "Common Agriculture Policy, the Cohesion Policy, R&D programs, and official development assistance" (Dabrowski, Marek 2010). However, regulation and supervision in financial markets is likely to fall under the legal purview of European institutions (Dabrowski, Marek 2010).

Although some kind of financial market regulation at the European level may be a welcome solution, other forms of federalism may serve as a more efficient tool for addressing the issues facing several euro area countries in the aftermath of the global financial crisis. Since the rigid economic rules of the Maastricht Treaty and SGP were incapable of preventing the fiscal divergence and economic instability that arose after the financial crisis, there is no guarantee that more rigid benchmarks are the solution. The Maastricht criteria and the SGP were either counterproductive in what they did address or deficient in other areas that were economically significant. Instead, loose regulations on some policies should replace the stricter numerical benchmarks of the SGP.

Institutional Arrangements in Response to the Debt Crisis

The European Financial Stability Mechanism (EFSM) emerged in May of 2010 as the primary institutional arrangement to address the sovereign debt crisis. In 2013, it will become a permanent body under the European Stability Mechanism (ESM), which will serve as an emergency lender to struggling countries within the Eurozone. The source of

funding for the EFSM and European Financial Stability Facility (EFSF) are bonds guaranteed by the EU budget and members of the EU. The EFSM is available to all EU countries, while funds from the EFSF are limited to Eurozone countries. The loans the EFSF can provide is lower than the total amount of money it raises because it uses "credit enhancements to guarantee the triple-A rating of the debt instruments issued by the EFSF. Accordingly, the EFSF has to retain a buffer to reassure investors that the states which back the debt issuances will honor their obligations" (Paliouras, Vaileios).

Much to the dismay of de Grauwe (2011), the EFSF lent emergency funds to Ireland at a 6% interest rate, which made it more difficult for Ireland to reduce its budget deficit and signaled to the markets that Ireland remains a significant default risk. The dynamic the EFSF created by imposing high interest rates on its rescue package made default more likely. De Grauwe (2011) suggested that the ESM should lend at a much lower rate in order to slow debt accumulation and create trust in the success of the rescue package. Such trust would supposedly assuage markets to the point of mirroring the ESM offering loans at lower interest rates as well.

De Grauwe (2011) was critical of collective actions clauses of the ESM, which state that private bondholders would have to accept debt restructuring whenever a Eurozone country seeks the assistance of the ESM. The problem with such clauses is that it will make bondholders more reticent to purchase sovereign debt and more willing to sell it, which would raise interest rates and force the country in question to seek ESM help anyway.

Another feature of the ESM is its imposition of austerity measures for countries seeking emergency funding, which would lead to the procyclical fiscal policies de

Grauwe (2011) believed countries should avoid. Although he lauded the idea of the ESM, de Grauwe (2011) believed that its design would make default more likely. Although he is correct in asserting that ESM rules accelerate the march towards default, the idea of the program is unsettling as well. The ESM is a Eurocentric recapitulation of other money transfer arrangements, meaning that the moral hazard (created by the assurance of outside aid) would remain intact.

The Euro Plus Pact is a less ambitious agreement than its preceding incarnations (The "Pact for Competitiveness" and the subsequent "Pact for the Euro"). The reason for diluting the provisions of the treaty is that proposals to end wage indexation and adoption of constitutional measures to rein in debt "were replaced by language calling for discretionary assessment of policies by the Member States" (Paliouras, Vaileios). The objectives of the agreement include "[fostering] competitiveness and employment, and to increase sustainability of public finances, as well as, to reinforce financial stability" (The European Council 2011). The Pact sought to lower ULCs, lower taxes on labor, and reform the pension system. Those reforms will fall under the purview of national governments and "will be mainly implemented through non-binding policy guidelines" (Paliouras, Vaileios).

Looser policy guidelines are a positive development in the Eurozone because they allow Member States the flexibility to undertake the necessary policies to reform their economies. Under a regime of looser guidelines, Member States either successfully tailor their policies to the peculiarities of their economic structures or ultimately assume full political ownership of their failures. Fiscal federalism works if Member States endure full *economic* ownership of their decisions as well.

Conclusion:

One of the difficulties EMU created for the economic periphery of the union prior to the adoption of the euro was that several countries had higher real (bank market) interest rates. Once the euro went into circulation, interest rates under the ECB converged at levels that were appropriate for an economy such as Germany, but not a Spain or Ireland. This problem was a function of certain countries rushing into euro adoption. As a result of several countries entering the currency union far too quickly, its members have engaged in several bureaucratic and policy measures that are little more than patchwork for a poorly designed system that came into existence earlier than it should have. One lesson of the debt crisis is that the Eurozone should be more careful in accepting new members in order to avoid the problems it currently faces.

Unlike Eichengreen (2009), Buti (2004) suggested softening of Eurozone rules. He observed that abolishing the SGP and letting member states "return to full political ownership of decisions" was the most preferable course of action. Even though he accepted that "EU institutions should be allowed to issue recommendations on Member States' public finances and encouraged to defend these in public discourse," he believed that Member States have the right to disagree and provide "national politics the last word in the procedure" (Buti, Marco 2004). Buti (2004) went on to insist that no supranational rules would be able to create the proper incentives to stabilize national economies and avoid "fiscal free-riding." He suggested that it would be a better idea to abolish the SGP altogether and rely on looser Broad Economic Policy Guidelines (BEPG's) instead.

Hallerberg (2010) proposed that market discipline was the best form of dealing with excessive Member State debt. He explained that several US states during the 1840s faced unsustainable debts, which they accumulated as a result of expensive investment projects (e.g. railroads, canals and state banks). Instead of stepping in to help, the federal government did nothing as many states defaulted or partially repudiated their debts. In the aftermath of the fiscal crises, voters in troubled US states demanded the adoption of fiscal rules in their constitutions. "By 1857, most state constitutions had a balanced budget amendment in their constitutions, and today 49 of 50 states have some version of this restriction" (Hallerberg, Mark 2008).

The development that emerged in the US during the middle of the 19th century seems to be in its nascent stages in the Eurozone with Italian Prime Minister, Silvio Berlusconi, promising to introduce a national balanced budget amendment that would balance Italy's finances by 2013 (Emsden, Christopher and Forelle 2011). The current wave of fiscal consolidation is not identical to what occurred in the mid-19th century in the US, because much of the current trend is accompanied by some outside institutional pressures in addition to the market pressures created by high interest rates. In light of the unsustainable economic policies Member States enact under coercion, less institutional pressure would yield better results.

Reform efforts in Member States lose domestic support when outside institutions are perceived to be imposing them. Aid intended for repaying unpopular holders of sovereign debt (e.g. banks) also creates audience costs when such aid is accompanied by austerity measures that reduce benefits for average citizens. Those measures serve to weaken the political standing of the union and make the monetary union more fragile as a

consequence. Taking taxpayer money from one country to transfer to another in an effort to repay large holders of debt creates animosity among citizens of the sender country as well. Therefore, leaders in the euro area would benefit from upholding the spirit of the no-bailout clauses of its agreements and allow banks to take losses on bad investments in the same manner that individuals do.

To Hallerberg (2008), market forces provide sufficient disciplinary measures necessary to stimulate genuine reforms. Those forces mitigate the need for additional bureaucratization of the currency union. Hallerberg (2008) welcomed high bond spreads because they provided a market-based punishment that essentially rendered the corrective arm of the SGP unnecessary. Market forces within EMU should be sufficient to correct the fiscal problems of the Eurozone's weaker economies.

Withdrawal from the currency union is unlikely for countries nearing default because abandoning the euro would not alleviate any of the debt burdens of the countries in question. The only way for those particular Member States to meet their debt obligations outside of the Eurozone is through massive money printing in national currencies that are already devalued. Risking runaway inflation and losing the privileges of EU membership are in no way preferable to debt restructuring within the euro area. Moreover, in light of the stress test the European Banking Authority (EBA) conducted in March of 2011, claims of widespread bank failure in the event of default exaggerate the scope of bank failure that would result within the Eurozone. Only 8 of the 90 banks that the study examined would fall short of the minimum capital requirement to stay afloat in the event of an economic contraction lasting two years. Additionally, most of the holdings in sovereign debt are held domestically (European Banking Authority 2011).

Any major widespread contagion of a Member State's default is certainly possible, but unlikely in the Eurozone.

Although the SGP's benchmarks and corrective framework were ineffective, its policy guidelines were constructive. Therefore loose BEPG's should replace any strict conditionality. EMU can still enjoy long-term success if its leaders decide to accept the short-term pain that would result from defaults and fiscal reforms of its structurally unsound economies. Although, the solution seems harsh, the Eurozone's economic bad actors have such a high disincentive to withdraw from the union that they would eventually enact the structural reforms necessary to ensure the viability and sustainability of their economies and the euro area as a whole. With the development of the ESM loan program and some variation of the increasingly popular Eurobond proposal, the Eichengreen (2009) prediction of greater centralization seems to be more likely. However, such a development may mask structural issues within individual member states and probably weaken the arrangement politically or economically.

Eurobonds or any measures to bureaucratize and centralize the monetary union are attempts to blur the signals that markets inevitably deliver. They treat the symptom of bad economic structures and fiscal mismanagement among the Eurozone periphery by pooling the risk of sovereign debt, but they do not resolve the underlying issues. BEPG's that allow for varying forms of labor and wage reforms are a step in the right direction. However, in light of the Felipe and Kumar (2011) analysis, peripheral Member States should find ways to produce and export more sophisticated goods in order to avoid wage competition with developing countries.

The only exception to the federalist solution pertains to the financial sector. If there is a large central bank issuing the currency for all 17 countries, then it should also be responsible for homogenizing banking and financial services regulation as well. Considering that low ECB interest rates led to excessive liquidity in Ireland and Spain, the Giavazzi and Spaventa (2010) proposal for some supervision on lending standards at the European level would also be constructive, but admittedly difficult to implement.

There is no guarantee that countries will end their fiscal profligacy under the common Eurobond framework. If a Member State eclipses the 60% of debt to GDP threshold and decides to issue Red bonds at higher interest rates, will they really have to repay it? Will they be able to pass the cost to the rest of the union by creating a systemic risk with the threat of default? Peripheral Eurozone countries may use the appeal of common Eurobonds to avoid the political backlash of undergoing fiscal consolidation. However, the prospective reward of Eurozone membership over a decade ago failed to have that effect.

Unless the threat of default forces countries to restructure their economies prior to joining the Eurobond framework, any form of a Eurobond will likely suffer the same credibility issues as the SGP. Consequently, the Eurobond may postpone the day of reckoning, but will ultimately be unable to force anything more than cosmetic and unsustainable policy changes. Leaders in the Eurozone core have already rejected the Eurobond proposal on the grounds that such pooling of debt would require a level of fiscal policy integration that does not yet exist within the union (Hollinger, Peggy 2011). However, the opinion of German and French leaders is subject to change because circumstances and the individuals in power are subject change as well. The problem with

homogenizing fiscal policy is that it would be way too big an endeavor for a central apparatus to embark on without large scale popular support and the ability to "exploit local information and deal with the large informational asymmetries" that is exceedingly difficult, if not impossible, at the transnational level (Boeri, Tito 2005).

The core economies of the euro area will likely accept the Eurobond after they decide that they cannot politically sustain the perceived costs of bank failures or money transfers in the form of low interest loans. They will probably support the Eurobond, however, with excessive conditionality that will stifle the necessary and beneficial attributes of fiscal federalism. In the end, the Eurobond and other measures toward institutional centralization would likely suffer the same fate as the SGP and bring about another crisis the next time the global economy experiences another major setback. However, if Member States have the ability to enact reforms under a more flexible arrangement, without the implicit or explicit guarantee of outside emergency aid, the Eurozone will flourish as the political and economic success its founders envisioned.

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