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Perspectives for the Euro-Zone: Consolidation, Collapse or Muddling Through?

Introduction

The monetary model of European integration has always been subject to debate in theoretical literature. From the very outset, many economists – especially in the United States – tended to believe that single currency is a mistake, if for no other reason, because of the lack of political union, and the ensuing lack of fiscal union[1]. The thrust of the argument goes as follows: voluntary co-ordination of policies, as stipulated by the basically intergovernmentalist arrangements of the EU in its post-Lisbon architecture, is insufficient to offset the imbalances resulting from a unified

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1 Jonung, Drea [2009] provide a meta-analysis of over five dozens of criticisms why the single currency should have collapsed from the very outset.

monetary policy in the absence of coordinated fiscal policies. More specifically, lacking the transfer mechanisms that exist inside national states to offset regional imbalances and also divergent responses to external shocks, the whole concept was bound to lead to trouble.

It is hard to deny that there is a modicum of truth in this argument, even though it is fairly textbookish economics and overlooks the difference between nation state and a community of states (in German: *Bundesstaat* – federal state – and *Staatenbund* – a commonwealth of nations). If we follow this logic, it is hard to escape the conclusion, recently proposed by Scharpf [2011], that any attempt to rescue the construct, as experienced in the 2008–2011 period, is bound to exacerbate the situation in both economic and political terms. It is because – so the argument goes – the current crisis only uncovers a number of democratic deficits and professional inefficiencies, lack of accountability and of enforcement mechanisms, deeply rooted in the political compromises having moulded the EU policies and institutions over the past decade or so. The contrarian argument, put forth by a number of analysts is that the EU is, by the crisis, triggered into the jump it has long and rightly feared, namely to move seriously towards political union, where burden sharing is although important, but not the only issue at stake. And indeed, a mere survey of major measures to fight the crisis [Benczes 2011] allows us to see attempts to coordinate and control fiscal spending, both in its size and patterns, to degrees and forms unseen ever before. The jump would imply complementing monetary union with a degree of open fiscal federalism, subordinating national fiscal policies to some of the common procedures, goals and measures.

History and logic of the EMU

While libraries have been produced to explain the emergence and functioning of the European Monetary Union, at times of crisis it is perhaps inevitable that fundamentals are being raised again and again. In the first part of this section we ask who benefits from the single currency, and in the second part we offer a brief survey of how we, as the Community, have got where we are now.

If one asks about benefits of the euro, rather straightforward answers can be given, both at the macro and micro levels. A single currency saves considerably on transaction costs, especially in a continent known for high banking fees and margins.

Furthermore, comparability of national prices allows for evolution of what is known in economics as the 'law of one price', *i.e* a tendency to equalize charges for the same output or service performed. In short, if the flow of commodities and services is free, competition and arbitrage creates a situation where prices no longer show the traditional wide spreads across the EU countries and regions. The process is well demonstrable through observation of wholesale and retail prices, basically across the board, including non-tradables. This has much to do with the opening up of markets along the Single European Act to global competition, but also to direct comparability of prices charged by individual suppliers, from airfares to foodstuffs.

Third, stiffening competition itself is a source of consumer benefit. Fourth, by creating a zone of stability, the currency zone is institutionalizing the gains of the period of 'Great Moderation' in terms of price stability and – ideally – also financial policies, both in the fiscal and monetary legs[2]. Finally, by creating a largely closed economy, comparable with that of the Unites States, the currency zone shelters its members from external shocks – so the conventional wisdom goes. This applies *a fortiori* for small open economies, where the efficiency of monetary and fiscal policies has long been undermined by processes of globalization and capital market liberalization.

How far have those theories stemmed from the facts? Historically speaking, the rather complex arrangements of the EMU [de Haan, Osterloo, Schoenmaker 2010] have never followed from pure theoretical considerations, that were grounded either in economics or in political science, let alone integration theory. In reality, the EMU – conceived several times and by several 'founding fathers' – has been by and large the outcome of decades of learning by doing. This took place in countries with very different histories, and especially following the oil shocks of 1973 and 1979, when the efficiency of conventional Keynesian demand management has been subjected to serious doubt.

All through the 1980s a steady and gradual conversion of one economy after the other to what many term as 'monetary orthodoxy' took place. One by one, countries adopted unilateral exchange rate pegs, turned away from fiscal profligacy and a *de facto* D-Mark union has been in the making. As shown in the insightful analysis of Issing *et al.* [2004], this was more of a series of trials and errors than adoption of any clear theoretical stance. And while insights from monetarism were playing a role, insights from other schools were at least as important. For instance, fixing the

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[2] This is clearly a normative statement, and the question if arrangements of the Stability and Growth Pact suffice for this to be delivered, has been a subject of debate from the very outset.

exchange rate has always been an anathema to any serious monetarist, ever since the publication of the fundamental article by Milton Friedman [1953].

Let us emphasise it: the practice of European monetary integration has therefore been by and large the opposite to what would have followed from monetarist teaching. Here the red thread has been the gradual conversion to exchange rate stability, later price stability and the discontinuation of the practice of fiscal profligacy. This long story [cf also Dyson and Featherstone 1999] has been, to a large degree, one of trials and errors all across the 1970s and 1980s. By the time the Maastricht Treaty was adopted in 1992, all political parties with a chance to get close to government, and any academic economist with an influence on policy-makers, either on left or the right, have been convinced of the virtues of price and exchange rate stability. By that time a *de facto* D-Mark zone emerged, with first small open economies like Austria and Finland, later large economies like France and Spain and finally Italy pegging their respective currencies unilaterally to the German mark, thereby importing stability.

Let us observe that this 'conversion to orthodoxy' was an outcome of *societal learning, not of academic consensus.* In the academic circles voices hostile to the European monetary project have always been strongly represented, not least because of the vocal opposition of the Anglo-American guild, providing the mainstream for economic thinking. However, experiences with competitive and occasional devaluations, with instability and volatility of exchange rate arrangements across the 1970s and 1980s have lent support to those practitioners who advocated the artificial creation of the zone of stability, *i.e* the currency union. Alas, this latter outcome is already in line with the then emerging wisdom of financial economics, the 'bipolar view' in which only irrevocably fixed or freely floating exchange rates are sustainable in the long run. The latter calls for small open economies, like those constituting the EU, to join into a currency bloc.

Therefore, joining the currency union has required no extra sacrifices in terms of 'giving up the exchange rate instrument', since such an instrument is out of the question among the countries forming an economic union. Furthermore, as literature has shown (Horvath, 2006 for summary), the criteria of optimal currency area to be largely endogenous, thus being self-fulfilling. Indeed, on the ground business cycles tended to be synchronized and intra-EU trade increased. Asymmetric shocks, an issue widely discussed in the literature, have not proven to be policy relevant, given the quite similar economic structures of the member-states, with intra-industry and intra-firm exchanges dominating over the traditional inter-industry or even inter-sectoral trade as postulated in the classic theorem of comparative advantage at Ricardo.

Measured against the background of truly severe external shocks having characterized the entire 1992–2012 period, it seems that the considerations and institutional arrangements of the EMU elaborated in a series of compromises and documented in the summary volumes cited above have proven viable and resistant to crisis. Neither inflation nor deflation emerged, and not only because the ECB adopted a more rigorous – and thus longer lasting – concept of recession than is customary in the United States. The harmonized index of consumer prices, *i.e* the indicator elaborated and regularly controlled by the joint statistical agency Eurostat, has never been below 0.6 per cent per annum and never exceeded 3.3 per cent – in the troublesome year of 2008. As a rule it fluctuated between 2.1 and 2.6 [Source, unless otherwise idicated: ECB 2011] per cent per annum, *i.e* slightly above the numerical target of the ECB[3], but *ensuring price stability for any practical purpose.* The single currency has remained strong, especially during times of the financial crisis of 2008–2009, against all competing currencies except the Swiss franc. The EU has never experienced any major current account deficits or surpluses. Current and capital account taken together fluctuated between a mere +0.2% and –1.4% per cent of joint GDP, even during the crisis period of 2007–2011. Thus the level of the cross exchange rate must be considered to be an equilibrium level, despite regular complaints by some politicians and industrial interests.

If we disregard those criticisms in literature as well as in the public discourse, which demand attaining objectives which are explicitly not assigned to the ECB, we get a clear picture. If we accept that any joint agency must follow its mandate, set by its statutes, the EMU actually has delivered what it promised: price stability for a long period, *i.e* over 13 years. *Criticisms blaming the single currency for what it is not constructed for*, or which is not to be influenced by monetary policy, are therefore *misdirected*. These criticisms are rarely born out by statistics, including the euro's alleged contractionary effects, unfavourable labour market impacts and the like. In the first run, thus, we have to consider the eurozone as a major success. This stands out especially as we compare this venture to other major policies of the EU, such as the Lisbon Agenda, enlargement, reforming common agricultural policy or improving the efficiency of cohesion funds, let alone the Doha Round of global trade

[3] Given that the ECB has never adopted a strategy of inflation targeting, much in fashion over the past decade in the academic literature, but not necessarily among major central banks, like the Swiss, Japanese or even the FED, the mere fact of numerical missing is irrelevant, as long as it is not sizable. Experience has led to the convention seeing privce stability somewhere between 2 and 3 per inflation cent per annum in order to remain on the safe side and avoid dflationary threats. More on that in Issing *et al.* 2004.

talks. Against the limited, if any, success of those areas, the single currency is one of the *unqualified success stories of European integration as a whole.* While the jury is still out if, and to which degree, this outcome is attributable to the monetary and especially the fiscal framework safeguarding the common currency, the fact of the matter is that on the Community level it seems to have worked.

We must add the proviso that the European Union has remained intergovernmentalist in its basic features. Therefore, it neither does nor it should have a body with supranational competences, able to enforce, in the worst case by military or other disciplinary measures, decisions taken at the Community level. Thereby we are at the popular theme of sanctions, widely discussed in literature. As long as fiscal policy, unlike monetary policy, is not vested in a single supranational centre, because it would contradict to democratic legitimacy, *fiscal cooperation, truly needed for successful monetary union, can only be based on voluntary compliance.* And this is the crux of the matter.

The European Union, ever since its inception, has been a club of gentlemen. In other words, cooperation was based on commonality of values, objectives and revealed preferences of the participants to do things together, attributing a value on its own to the factor of doing things together. This idea of the 'ever closer union' has been formative all across the history of the EU, acting as the driving force for various projects of deepening. In this context, sanctioning, let alone excluding any of the participants, would run against the spirit of the entire enterprise. Therefore – as external observers have never been slow to pinpoint – rather weak, if any, sanctions on trespassers, be that basically in any areas of common policies. While in exceptional cases the European Court of Justice may superimpose Community legislation over national decisions, however *this is exceptional, rather than recurring, let alone regular.* The attempts in the 1997–2009 to politicize and federalize Europe have foundered, therefore this state of affairs must be taken as a given [more on that in Csaba 2009, chapters 6 and 7].

Mafiosi in the club

Let us recall: all European policies and institutions are based upon voluntary compliance and goodwill, thus in each and every of the policy areas the spirit of co-operation is being pre-supposed. For instance, it is not obligatory for any member-state to join the single currency[4]. It is possible to join the European Security and Defence Policy or not. The model of flying geese [de Andrade 2005] is an apt analogy to the already evolving multi-speed model of integration, where members involved in more or less intense cooperation work together in the long run. A recent example is the Competitiveness Pact, signed in June 2011, when four very different members – Britain, Sweden, Hungary and the Czech Republic – decided to abstain, obviously each on entirely different grounds.

This 'soft law' nature of European arrangements also implies that identification with the Community ownership – much the same as IMF parlance would call 'domestic ownership of reforms' – is even more important than otherwise. Law abiding behaviour in general pre-supposes the agents' internal identification with values and objectives, formalized – always imperfectly – by the legislators. In case of conflict, the spirit of the law, the intention of the legislator is a matter for concern, up to the point of being decisive in settling court cases.

From this angle it should have been disturbing to see an ever growing number of states openly dodging the commonly elaborated arrangements. Beetsma *et al.* [2009] elaborate in great length that the stiffening of controls at times when players do not identify with the logic/value judgements behind the formal rules, has actually induced *regular and large scale cheating across the board*. This was the case with fiscal policies, an issue we shall address in some detail.

It is certainly difficult to provide a lump sum assessment of complex developments of an entire decade, that between 1999–2009. However, two or three general remarks may suffice for our purpose. *First,* as we have seen above, in the first decade – and actually until the eruption of the Greek crisis – the arrangements, however half-hearted, seem to have sufficed for sustaining price stability, and the exchange rate against the dollar even appreciated. *Second,* even if in a very incremental manner, debt/GDP ratios in most eurozone countries tended to decline, approaching the Maastricht limit by 66.3% in 2007, before exploding, as a sign of Keynesian crisis management, to 85.3% by the end of 2010 [ECB: 46]. *Third,* in the years of the Great Moderation of the 1992–2008 period, there was a general tendency, both in much of the academe and the policy-making influenced by them, for believing that crises will never come back. What is seen from today's perspective as complacency was

[4] Technically speaking, new members, including Sweden and the East, are compelled by the accession agreements to join. However, Sweeden has deliberately abstained, not least because of the referendum held in September, 2003, and most Eastern members simply do not seem to qualify in the current decade.

fairly widespread, both in the academic literature and in policy-making. Thus, acting on the fiscal front, calling for more stringency, or merely complaining about the lackluster efforts at structural items of fiscal consolidation sounded overzelous and pedantic textbook economics, especially to practitioners on the market and in the state administration alike.

It should be observed that a number of countries were performing well, or even extremely well, such as Ireland until 2008, Estonia, Luxembourg, Finland, Spain, Slovenia and Slovakia, but the performance of the Netherlands, Austria and Cyprus seemed acceptable, as well. Some countries outside the eurozone, such as Bulgaria, Latvia, Denmark, Lithuania, the Czech Republic, Romania, Sweden and even Poland were, even in 2010, well within the Maastricht set limits of debt ratios. In other words, *we do not see any evidence,* theoretical or empirical, that would warrant the usual litany of some economists *about the irrationality, unfeasibility, non-practicality of meeting the Maastricht criteria at a generalized level.* Moreover, if we note that the extensive Scandinavian welfare states all fared very well under this criterion too, the doubt seems more than justified.

Under this angle we may propose the hypothesis that countries which were severely derailed in the 2008–2011 period, were the ones where some fundamental features of economic policies went wrong, and that for a longer period of time. For if public debt explodes without any preliminaries, it must be a reflection of some previously covert structural imbalances in the given economy. And it is hard not to observe that the asset bubble in both Ireland and Spain, the mismanagement of banks in Greece and Ireland, the dodging of structural reforms in Portugal, and not least Italy[5], all count among the platitudes of the literature by now. The hopeless state of Italian public finances is not to be observed with surprise since it counts among the evergreens of the public finance literature over the past few decades. One may indeed wonder, especially against the background of the wide acceptance of the theorem of efficient markets in the pre-crisis decade, how the allegedly super-rational, fully informed and ruthless capital markets allowed Italy to get away with its lousy and non-improving public finances, chronic deficits and 100 per cent plus debt rates, without even attempting to deliver the punishment, which according to finance textbooks, should have been 'instantaneous' and devastating.

[5] The long overdue and still somewhat unexpectedly timed demise of Silvio Berlusconi, in November, 2011 following the G20 summit of Cannes, was just the latest and most conspicuous casuality in the saga.

In short, it seems rather straightforward that problems that emerged by the countries listed above are *peculiar to the individual economy on the one hand, and have fairly little, if anything to do with the common framework* of fiscal coordination, let alone with the joint policies spending a mere one per cent of the joint GNI of the EU members. By contrast, the trespassing, with or without EMU, has been flagrant and extreme, recurring and structural in nature, indeed, in each and every of the cases.

By the same token, it is important to underline: the nature of each of the respective crises has been different, not least because these were not attributable primarily to EMU and SGP arrangements. True, EMU, by allowing for cheap financing for heavily indebted countries, irrespective of their debt burden, and also ECB practices of accepting debt obligations of heavily indebted countries without a discount, in the name of mutuality, solidarity and single currency zone without differentiation, all *contributed to the ills.* But it would be hard to ascribe the ills *in toto* or even in their bulk to an arrangement which has by no means caused similar outcomes in countries with different policy options. The number of the latter, as listed above, is considerable.

Let us merely note how different the respective crises by the country has been! In the case of Ireland, the overheating of the economy, an asset bubble and lack of regulation, as well as lasting inaction by the governmental agencies at times when the crises was already open, taken together, created the trouble [Honohan 2010]. In short, this was a trouble with overheating, with non-interventionism and an overdose of *laissez-faire*, which created parallel bubbles in the construction sector as well as in banking financing those. By contrast, Portugal, according to all accounts, has been a country with miniscule if any productivity growth, with little if any economic dynamism, minimalist policies across the board and the ensuing lag in terms of competitiveness, indicated emphatically already years ago, *inter alia* by Blanchard [2006]. Finally, Greece is an entirely separate case, where analysts highlight the *de facto* failure of the Greek state [Featherstone 2011] as well as the political instrumentalization of various adjustment packages for domestic policy ends, irrespective of longer term ramifications [Visvizi 2011]. This experience, elaborated in detail in the paper cited above, is by and large a reflection of a popular attitude just opposite to what proponent of fiscal federalism [Hallerberg 2011] consider as necessary pre-condition for their suggestion to work on the ground. Namely: a popular opinion holding policy-makers responsible for fiscal irresponsibility and non-remedying structural reasons in which the dismal outcomes are rooted in each of the troubled countries.

What we find in common in the three open crisis cases is the fundamental incongruence of domestic policies and institutions with the underlying logic of the monetary model of European integration, and even with the basic logic of political integration, understood as a deepening project. Once a member no longer identifies itself – at the level of decision-makers and elites – with the original project of the political union, or *finalité politique,* the specific arrangements that emerge as an outcome of intergovernmental bargains may look absurd, irrational and of limited use (to attain the pedestrian, immediate targets of the policy-makers). Once this assessment prevails, *a minimalist approach replaces the traditional commitment to European goals.* While the latter has long helped overcome the crises, which is rightly seen as the *modus operandi* of European integration in most of its fifty plus years of existence, the lack of commitment, foot dragging over macroeconomically insignificant issues and financial flows, and generally, playing a theatre scene for domestic audiences instead of focusing on the solution of the Community goals, both in the technical and political planes, translates into inaction and drifting. The defining feature of the 2008–2011 period has been the collapse of the Great Moderation and the peaceful waters that used to characterize that period. By contrast, ever since the eruption of the financial crisis and the domino effect on a number of EU countries[6], fire fighting has replaced strategic thinking. Managing the task of the day clearly prevails over any broader consideration, including the strategy of the EU, the Europe 2020 project[7].

How to solve the insolvable equation?

Crisis management in the EU has, by the time of writing, reached a new dimension. First and foremost, the global economy has not returned to the normalcy of the pre-2008 period, not least because of the *crisis of confidence* which rules on financial markets. Most players remain unconvinced both about the ability and willingness of

[6] These included, besides the three chronic cases, also Latvia, Hungary, Romania, Spain and Italy, the first three having to resort to IMF standby packages, a measure that used to be axiomatically excluded from the policy options of any EU member in the pre-2008 period.

[7] For a thorough and controversial assessment of the strategy, immediately upon its promulgation, cf the Forum discussion in: *Intereconomics* 2010, 45(3) .

major governments to manage their public debt, which is only exacerbated by these governments – implicitly and explicitly – assuming responsibility for a large part of private debts in their countries[8]. Indeed, for market players the insight, highlighted perhaps most by Reinhart and Rogoff [2009], that there is no Chinese wall between public and private debts accumulated in the same country, implies a Copernican turn in the way market participants evaluate macroeconomic indicators. It is not least because of *the additive nature of the two debt mountains* that undermined the faith of markets in governmental policy, which in 2009–2011 showed little if any commitment to revert the tendency, which is obviously a warning sign, according to the historic evidence marshalled by the book cited above. By the same token, combined fiscal and monetary easing, as practised in the USA, can do precious little for alleviating the problem, which is not rooted in effective demand, but in actors' anticipating further worsening, quite in line with the traditional Lucas critique (1976) of the inefficiency of such policies.

The period 2009–2011 has seen an unprecedented degree of attempts to create new mechanisms for fire-fighting, crisis management and also to bring about a sustainable and lasting, permanent mechanism of pre-emption and cure, the European Stability Mechanism, effective from 2013. Without attempting to provide a detailed summary of this issue, which is extremely complex both in terms of management techniques and in terms of institutional arrangements [cf the broad-brush summary by Benczes 2011] let us make just a few general remarks at the level of systemic discussion, in line with the genre of the current paper.

First and foremost, the three open crises, exacerbated by the eruption of previously covert, but lasting instability in Italy[9], and to a lesser extent in Spain, have made the underlying contradiction between sustaining intergovernmentalism in decision-making and supranationalism in terms of substance. The latter is particularly clear when national debts are 'mutualized', to use the euphemism by former Commission president Jacques Delors, when the idea of issuing common European debt obligations has been gaining acceptance, and when the 'de facto co-funding of individually made

[8] Iceland is perhaps an extreme case where the government guaranteed the repayment of all deposits, way above the 20 thosand Euro limit stipulated by EU banking regulations. But bailing out big firms, like GM and Chysler, or big banks, like Fortys or Hypo Vereinsbank, implied by and large the same for the fiscal position of the respective countries.

[9] According to the *Wall Street Journal,* September10, 2011, over 70% of the bond burchases by the ECB, reaching close to €80 bn, was directed to the troubled southern members, leading to the ECB owing the larger part of external government debt of these nations, which is bizarre, given the statutory prohibition protecting the ECB from financing any government debt.

debts, explicitly forbidden by the Stability and Growth Pact is becoming an ongoing practice'.

It is perhaps unsurprising to see the former socialist leaders, themselves largely responsible for the explosion of debt, calling for more solidarity and in fact community level decisions on fiscal policy[10]. But it is perhaps equally unsurprising to see the conspicuous resignation of German guardians of price stability from ECB positions. The resignation of former Bundesbank President Axel Weber in April, 2011,who used to be widely and safely tipped to be the successor to ECB President Jean-Claude Trichet, was later followed by the vocal and emotionally argued resignation of chief economist Jürgen Stark [2011]. These are though tips of the iceberg, still reflect the deep and unbridged division over the fundamentals.

Second, we may formulate the strain as follows: if the SGP contains an explicit no-bailout clause, the idea of political community and European solidarity also contains *an implicit no bankruptcy clause.* As we have argued above, for a decade the two contradictory considerations seem to have been co-existing pretty well. But once the fundamental assumptions over gentlemanly behaviour are violated, when the Irish, Greek and the former socialist Portuguese governments run openly counter to their own obligations to revert the financial catastrophe, a system based on understandings and the spirit of co-operation was clearly and openly challenged. This is why many observers by now talk about the crisis of the periphery being gradually but irrevocably transformed into the crisis of the euro-system. For if it is a recurring practice of non-abiding with the rules followed by non-sanctions, it is clearly a sign of erosion of the arrangement as a whole.

Third, it is hard to overlook that policy improvisation without a map – or what Germans would call *Ordnungsdenken* – inevitably leads to a dead alley. For even if we were sympathetic to the policy-makers acting under informational constraints and bounded rationality, that would not help us over the unresolved fundamentals, which are like a devil coming back through the window once thrown out of the door.

To cut a long story short, the 12 years leading up to the adoption of the Lisbon Treaty was an attempt to politicize and deepen the European Union. Whatever the reasons – and those range from the reign of popular media to the decreasing democratic legitimacy of top EU rulers bargaining behind closed doors[11] – the outcome has clearly been an outright rejection of anything, even symbolically, supranational

[10] Cf *Handelsblatt* [2011], September 10.

[11] This is the core of the lack of legitimacy argument advanced in detailed by Scharpf [2011], rightly reminding of the lack of transparency and direct accountability of Ecofin and Council decisions.

and avowedly federalist. Reh [2009] rightly talks about the de-constituting of the Union in and by the Lisbon Treaty, implying the watering down of the top-down, federalist and structurally binding components of previous drafts.

By the same token it is ironic to see propositions, such as that coming from the Dutch Prime Minister and the Minister of Finance where fiscal trespassing by an other member state could be actually punished, to the point of ejecting the sinner from the euro-club. Let us recall: it is not about the compelling nature or the economic rationality of their argument, which is also questionable, since the need to overcome the obvious moral hazard implicit in the ways the 2009–2011 crises were managed are clear. It is just that the constitutional, legal, political and thus technical pre-conditions have not been created, and even consciously weakened.

The long lasting row between the European Parliament, employing its enhanced powers of co-decision, anchored in the Lisbon Treaty on the one hand, and the traditionally all-powerful and single-handedly acting Council over the quasi-automatic nature of sanctions to be hanged over trespassers is just a formal sign of a deeper problem. For issuing eurobonds, or accepting government bonds of highly indebted countries as a collateral, without a discount, equals to re-tailoring the burden of debt at the Community level, *without, however, enjoying the legitimacy of the citizens,* who will, at the end of the day, have to foot the bill, now or in later generations. While technically speaking it could help alleviate the problem of heavily indebted countries, in political and legal terms it remains a non-starter. The less transparency and accountability, required in usual banking and business practices, the more so, since it remains entirely opaque who will foot which part of the bill and in what timeline.

And here we have come to a true borderline. European financial solidarity without political foundations, *without checks and balances, without remedying mechanism* and enforcing accountability of those responsible for the dismal outcomes, *comparable to those existing in the corporate world*[12], or even in the much sheltered medical profession, is a *contradiction in terms* anyway. Therefore far reaching suggestions to strengthen actual fiscal federalism along the lines of the Brazilian example [Hallerberg 2011] are missing the point. At the end of the day, Brazil has been a federal state, with centralized conduct of fiscal policy, which the European Union has never

12 Leaders responsible for the Enron scandal were sent to jail, and practices of Goldman Sachs during its 2008–2009 crisis operations are being subject to political and criminal investigation even at the time of writing. Nothing comparable looks conceivable for those who falsified statistics or were creating the balooning public debt.

been. Moreover the formative features of the most recent editions of the Treaty on the European Union, though accommodate measures already taken in setting up the European Financial Stabilization Facility and the European Stability Mechanism, still clearly fall short of delegating, even in part, responsibility for the conduct of fiscal policy to anybody 'in Brussels'.

Options for the future

It goes without saying that any forecast is a speculative exercise here. The experience of the 2007–2011 period in the EU has casted doubt over the majority approach in the literature which took for granted continuation of muddling through as the baseline scenario for any policy-relevant analysis. With the time passing, day by day new options become politically feasible, even ones that used to belong to the realm of fantasy only a few months before.

The *first option,* which is being pushed by the creditor countries, mainly Finland, the Netherlands and Slovakia, would openly move toward *a degree of formal fiscal federalism.* This has long been a proposal in the EU literature, still was constantly rejected on political grounds. One would need to see how fiscal rationality would be able to dominate the underlying political, legal, historic and emotional considerations. Asking for collateral *per se* is anything but appalling. However, when the Finnish Minister of Finance suggested something similar, it triggered Greek outrage, understandably so. But in the Community, where the Competitiveness Pact with its much softer arrangements was adopted by less than unanimity, generalizing stricter solutions does not seem to be trivial.

The *second option* is return to the old ways, including reliance on understandings and compliance basically through *voluntary action, gradual adjustment and coordinated external finance.* This would pre-suppose a co-operative and even ambitious approach from the debtor side, a case which one can observe in the case of Portugal and Spain, however not in that of Greece or Ireland, the major culprits.

Finally, *a third possibility is one of disintegration,* where some member states either leave the eurozone or are expelled by the others. This option, long forecast by American and academic critics of the EMU, would solve one problem by creating two new ones. First, the exiting country, adopting its old currency, is likely to fall even deeper in inflation and recession, owing to the foreseeable devaluation of the national currency. Second, this would be a heavy blow to the entire European project, whose significance is perhaps beyond our ability to understand. The old continent without over-arching political and institutional cohesion has, indeed, been a dangerous place, primarily for its inhabitants in the entire three centuries following 1648.

Irrespective of which of the options will materialize, it seems that current magnitudes of external debts, such as of Ireland and of Greece, having reached 96.8% and 142.8% respectively as of the end of 2010[13], which continued to grow ever since, are unlikely to be managed in any organized way, short of an open default and debt restructuring. This option materialized in part in November 2011, however it left the larger part of the outstanding, owned by the public authorities, unresolved. If a country is contracting by 7.5% and external debt service is over 8%, as in the case of Greece in 2011, the situation is unsustainable. The solution might lie in the resort to Brady bonds, which allow for avoiding open rescheduling, while allowing for swapping the official debts at a 50% discount to market agents. This option, practised in managing the Latin American debts of the 1980s, allowed the heavily indebted countries to restructure their economies and grow out of debt in a sustainable manner[14].

Likewise, the tripling of Irish debt in 2007–2010, as well as the initial unwillingness of the new government to follow the logic of IMF-EU rescue package, created a situation where return to the pre-crisis normalcy is likely to be slow and incremental, despite the considerable progress made by the workout process in 2011. While the situation of the two nations is dissimilar, and so is Portugal and Spain compared to the others, arithmetic remains arithmetic, and sustainability conditions are yet to be worked out by those involved.

The ensuing downgrading of some major French and Swiss banks is a smaller evil. General, open and organized debt restructuring, including public debt, is perhaps the only way to return to civilized exchanges, growth and solid policies for the decades to come. While the fact, that discourse using previously forbidden words, such as restructuring, reorganization, rescheduling and reorganization is welcome, formative details are less than trivial at the time of writing.

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13 These are the last numbers officially certified by Eurostat and ECB in: ECB [2011: 46], any more recent data are sheer estimates.

14 Here the major problem may lie in the fact, that neither ECB nor IMF, currently holding governing bonds of the problem nations, is allowed by its statutes to sell those claims at a discount and cover the loss from their reserves, as private banks or indeed fiscal authorities may do.

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