Sapienza
Università Editrice

ANNALI DEL DIPARTIMENTO DI METODI E MODELLI PER L'ECONOMIA IL TERRITORIO E LA FINANZA

2018

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Piazzale Aldo Moro 5 – 00185 Roma

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Iscrizione Registro Operatori Comunicazione n. 11420

ISSN: 2385-0825

Pubblicato a novembre 2018

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SOME PROPOSALS FOR A DEMOCRATIC AND PROGRESSIVE EMU

Abstract: The paper deals first with the asymmetries existing in the European Monetary Union (EMU) between the peripheral countries and core countries. Macroeconomic imbalances in terms of public budget and current account descended from these asymmetries and from the EMU institutional set-up. The paper also investigates the theoretical inspirations – based on monetarist and rational expectations theories - and the country and sectional interests underlying this set-up. Theoretical progress has however intervened in the last couple of decades that makes this set up obsolete. The need for new institutions then arises, even if their realization is contrasted especially by core countries. After designing the desirable goals of a new Monetary Union, the paper indicates the need for a more democratic Union and a possible articulation of new common institutions. The possibility of a country's exit from the Union and the costs and benefits related to this process are also discussed. Even if net costs might derive in the short run, the threat of exit can add to its bargaining power subject to the hegemony of core countries.

Keywords: asymmetries, democracy, EMU, imbalances, institutions, reforms.

1. Introduction

The institutional design European Monetary Union (EMU) is essentially based on markets and the single money, geared by the European Central Bank (ECB). Constraints operate on a country's fiscal policy (the Stability and Growth Pact and the fiscal compact, which limit fiscal deficit and debt), and there are some financial regulations, including the Banking Union and an asymmetric Macroeconomic Imbalance Procedure (MIP), limiting current account deficits to 4%, whereas current account surpluses can be no higher than 6.0%. This design together with pre-existing asymmetries has caused imbalances between core and peripheral countries.

Section 2 deals with asymmetries and imbalances. Section 3 investigates the theoretical inspirations and the interests underlying the institutional set-up. The theoretical progress intervened in the last couple of decades and the need for new institutions are also sketched. After designing in Section 4 the desirable goals of the EMU in terms of growth and crisis-avoidance, we indicate in Section 5 the need for a more democratic Union and a possible articulation of new common institutions. Section 6 discusses the option of exiting the EMU. The final section briefly deals with a federalist perspective.

2. Asymmetries and imbalances untackled by EMU institutions

Contrary to previous opinions, the structural and behavioural changes that were expected in the stage preparatory to the EMU institutions were not implemented or were only partial, at least in some countries, i.e. in peripheral countries. There was no synchronization of economic and financial variables as well as of their underlying microeconomic fundamentals. There were inefficiencies in the private and public sector, especially of higher inflation countries. Facing these inefficiencies and high costs, Germany cut its wages both before and after the establishment of the EMU. The monetary union has not got rid of the asymmetries and has possibly even enlarged them. Neither the action of agents nor formal and informal

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institutions have acted, at least so as to avoid the formation or permanence of large macroeconomic imbalances. Our analysis will try to explain the role played by the Euro Area institutions and policies.

National accounts establish some fundamental identities that must be taken into account for understanding the relevant issues and implementing appropriate solutions. For any open economy an identity links the private financing imbalance to the external and to the government's fiscal imbalances (Acocella, 2018). This shows how external imbalances, even in the absence of fiscal irresponsibility, can lead to accumulating public debt, capital outflows, and a financial sector liquidity crisis in which private debt must be replaced by public debt. Fiscal irresponsibility, as in the case of Greece, but not of other peripheral countries, simply adds to imbalances.

Three potential imbalances (in public finances, the private sector and the current account) must be controlled in a static context. This requires three independent, but coordinated, policies. Financial regulation can address private-financing imbalances; fiscal controls can ensure public accounts balances; structural measures (and when possible, monetary or currency policy) should ensure competitiveness and current account balances.

The general picture of most EMU countries up to 2007 can be depicted as follows, by grouping them under three types (using name abbreviations):

1. In a group of countries (D, NL, A) a private credit problem originated by low inflation rates, which - given the equal nominal interest rates - gave an incentive to lend abroad to other EMU countries. The counterpart to this were current account surpluses, which arose out of tight fiscal policies and the lower inflation profile, which added to competitiveness in all these countries. In some cases, as in Germany, we can speak of a true export-led strategy favoured by both private (unions and firms) and public institutions. Initial imbalances in the public sector in some countries (Germany) were ruled out over time.
2. The second group (GR, P and, possibly, IT) includes countries with fiscal profligacy and high inflation rates, which, on the one hand, led to current account deficits and, on the other, stimulated (or derived from) excess investment over savings, associated with asset bubbles. This exemplifies a case of debt-led growth.
3. In the third group (S, IR) there was no fiscal profligacy, even if the high inflation rates led to capital account surpluses (and thus deficits in terms of current account) and excess investment over savings, associated with asset bubbles. This is again a case of debt-led growth. In these peripheral countries, public deficit and debt tended to fall more than in some core countries, such as France and Germany.

This shows that there were two drivers of growth in the EMU, export and debt (both private and public). It also shows that not all the governments of peripheral countries accumulated or increased public imbalances, which is true for those of group 2 above, not for group 3. This negates the view of the European sovereign debt crisis as due to countries in the peripheral countries that were fiscally irresponsible and failed to implement pro-competitive supply side policies.

The main common driving factor can be indicated in the foreign account imbalances, to which fiscal profligacy added in some countries. By contrast, thriftiness added in the opposite sense in other countries. Wage policy can largely explain this factor (e.g., Stockhammer and Onaran, 2012).

Capital account balances are the symmetric part of current account ones. Indeed, capital flew from Germany and other countries having a current account surplus to peripheral countries, which means that the former countries lent money to the latter. Thus, opposing the 'sin' of those that borrowed there is the 'sin' of lenders, which irresponsibly lent their money to unlikely solvent banks. Indeed, from this point of view, one can say that 'it takes two to tango'.[1]

One of the common factors stimulating both current and capital account imbalances is inflation divergence between the EMU countries (Acocella and Pasimeni, 2017). The increase in net capital flows acted as an internal system of transfers, operating through the private sector via financial markets rather than through a common fiscal capacity, but the effects were quite similar. The transfers allowed a reduction

[1] This is the title of a 1952 song by Al Hoffman and Dick Manning, used by Lagarde (2010) to indicate the need of two (categories of) people for a performance. The expression of 'sinners' and 'saints' is used by Matthijs and McNamara (2015).

in unemployment in peripheral countries and contributed to higher inflation and to asset bubbles in these countries thus avoiding a deflationary environment. This had a kind of multiplier effect on itself, as behind inflation there were not only – or mainly - inefficiencies, but also the asset bubbles created by capital inflows. (To both fiscal profligacy in some countries is to add.)

The imbalances were of a kind that could not be overcome easily. There was indeed no mechanism embedded in the EMU – possibly of the kind at work in a fixed exchange rate standard – to ensure that. In fact, there are vital differences between a fixed-rate arrangement such as the one born at Bretton Woods with the IMF - which allowed for changes in the parity in case of 'fundamental imbalances' and also initially did not allow complete capital mobility – and the EMU, where there can be no change of parities, and freedom of capital mobility is a basic tenet of the Union.

Imbalances left the deficit countries vulnerable to a sudden capital stop or reversal of capital flows. In fact, investors from surplus countries decided that supplying finance to deficit countries had become too risky when the financial crisis hit the Euro Area and governments had to save ailing banks.[2] At that point, both the public and private debt had become high enough to threaten non-repayment and possible default. By contrast, official documents by the European Commission (1990, 1991) and analytical contributions by some economists, e.g. Blanchard and Giavazzi (2002), claimed that policymakers could feel safe to ignore any current account imbalances, as capital movements would always equalize the balance of payments, which will no longer be a constraint to policy. Once the imbalances manifested themselves, EMU policymakers adopted a position of benign neglect and did not remove their roots.

3. A few considerations on the foundations of the institutions

Behind the institutional set-up of the EMU there are some original 'biases' that derive from two roots. One has to do with the theoretical orientation that had developed before the Maastricht Treaty since the end of the 1960s. The essence of the credo it inspired was based on the virtues of free markets and policy rules, contrasting with the ineffectiveness and inefficiency of discretionary government action. The treaties designing the EMU institutions, in fact, embed the principles of the neo-liberal doctrine. Fitoussi and Saraceno (2013) depict them as the fruit of a true Berlin-Washington Consensus, reproducing – and in some cases anticipating the Washington Consensus.

In fact, in prescribing structural and deflationary policies, they do not consider, for example, the link between current and potential output, thus condemning the Euro-area to lasting low growth. Suffice it to say here that the pre-dominant theoretical influences were those of monetarism and the rational expectations theory, not of the theory of optimal currency areas.

In the last two decades or so, economic theory has questioned the system of analytical conclusions and beliefs that had emerged in the twenty years or so since the end of the 1960s, even if it still retains some assumptions that led to the propositions featuring that credo. Three decades later, faith in the mainstream credo would again be crowded out by the analytical developments (and some empirical findings) intervened in these years. Think, in particular, of:

- the limitations in the functioning of markets, especially capital markets, with specific reference to herd behaviour, reminiscent of Keynes's (1936) 'beauty contest';
- the irrelevance of many critiques to the 'classical' theory of economic policy (in particular, to Tinbergen's 'golden rule' about controlling the economy) based on rational expectations;
- the theoretical and practical limits to time inconsistency, when policymakers have enough instruments, and thus related prescriptions of the monetary policy rules that should replace discretionary action;
- the existence of a long-run non-vertical Phillips curve;
- the effectiveness of a more active fiscal policy and regulation (especially of financial markets and institutions) once some unrealistic assumptions of current models are ruled out;

[2] A stimulus to capital repatriation derived from the October 2010 declaration by Sarkozy and Merkel of their intention to call private investors to participate in losses on sovereign bonds.

- critique of the arguments put forward by Rogoff in favour of the political independence of central banks;
- sub-optimality of a conservative central bank in a monetary union with active trade unions, but benefits from fiscal coordination when a conservative central bank operates;
- demonstration of the need for an inflation target well above zero;

The other bias of the EMU design derives from the sectional and country interests that promoted its implementation or benefitted from it, also when the various elements of the theoretical setting were criticized or became obsolete. We refer, for example, to German savers, who were interested in having an environment of 'sound' money. But also the interests of some countries were pursued, for instance, in having an independent and conservative central bank. This could, on the one hand, pursue the interests of the important sector of savers and, on the other, was consistent with its export led strategy. Obviously, the two biases are linked to one another. Nevertheless, one can clearly trace the predominant vision that led to the adoption of an institutional set up based on rules, rigor, and market (rather than flexibility and adaptability), on the one hand, and the interests at play both in the institutional set up and policy actions especially after the emergence of the financial crisis, on the other hand (see more in Acocella, 2018).[3]

4. For an EMU fostering growth and not prone to crises: availing of theoretical progresses

The first sub-section deals with some possible new goals to be considered in a reform of EMU institutions and their possible design. The second sub-section complements discussion of new goals by discussing the choice of a new growth strategy.

4.1. A new design for the EMU

The Euro-area's institutional architecture needs to be designed anew, taking account of its failures as well as the novelties in the theoretical and empirical achievements of economic analysis in the last decades. Mostly, a new contract among the member countries should be drafted, as new goals – or a redefinition of the previous goals and rebalance of their relative weights – must be agreed upon. If these new targets are accepted, with a reduction in the relevance of monetary stability, a higher weight on employment, growth, financial stability and fairness, reasoning on the most appropriate reforms and instruments is easier.

In order to complete the indication of macroeconomic goals, let us consider the case where different - and possibly opposing - strategies are independently pursued by each country, as was really the case in the Euro Area. Recalling their essential traits could be useful. We refer in particular to the case of decentralized decisions on wage dynamics. Keeping nominal wage growth below productivity (as Germany has done for decades) tends to raise profits and lower the wage share, thus reducing domestic demand (because of the negative effects on consumption), if there is no corresponding increase in investment. If exports increase – and such a strategy of wage dynamics undoubtedly tends to incentivize this - the problem of a lack of aggregate demand and growth can be solved, but demand abroad in the rest of the Euro Area will be reduced. In addition, this strategy can be pursued by one big country only, in a closed economy like the EMU.

In a similar way, and as a consequence of following this strategy, if another country, running a current account deficit, borrows capital from the country with an export-led strategy, in the short run it can enjoy growth led by a credit rise or, at least partially, counteract the negative effects of the strategy pursued by the country adopting a beggar-my-neighbour attitude. However, in the longer run it can suffer from the asymmetric shocks that arise, as these, in turn, to some extent negatively affect also the export-led country.

[3] To cite an example, Brunnermeier et al. (2016) deal at length with the battle of ideas, which they label as the 'German' (or Nordic) and the French (or Southern) view, tracing them, respectively, to Kant and Machiavelli or, with reference to the recent history of economic ideas, to the clash between rules versus discretion.

The benefit should then be clear not only of reducing permitted current account imbalances and of making them symmetric (which completes the tetralogy of macroeconomic targets to pursue), but also of searching for a common strategy. More generally, a complete and satisfying re-design would require at least the following changes:

- Institutional reforms putting less emphasis on the virtues of the operation of markets and the common currency.
- A change in the ECB goals and statute, starting from the redefinition of the inflation target, to set a higher ceiling, downgrading the predominant role of anti-inflationary policies in a way to leave more room for the employment and financial stability goals, in a way similar to the Federal Reserve. What is more, the model of the Bank of England could be followed, with no political independence and the goals of inflation, set, in our case, on an annual basis by the European Commission.
- An increased role of other common policies, in particular fiscal policy. The common budget should thus be increased in order to permit anti-cyclical action as well as to design common investment strategies to foster a uniform growth throughout the Union. The budget should perform a stabilization role proper (for symmetric shocks) and an insurance function (for asymmetric shocks). A common welfare system, and other microeconomic policies, should be devised to make structural adjustments of the economies possible in the direction of a higher efficiency. This, again, requires an increase in the size of the common budget. Macroeconomic policies to reduce the existing asymmetric actions foreseen in the macroeconomic imbalance procedure devised in 2011 should also be enacted.
- The institution of a system of incentives to change, as the one suggested by Steinbach (2016). This author proposes to redesign treaties and statutes by introducing either contractual agreements between the EU and individual Member States, underpinned by financial support offering an incentive, or mutual agreements concluded between Member States for the implementation of structural reforms. According to Belke (2016), the Excessive Deficit Procedure does not offer incentives and sanctions to countries better than those of market-based interest rates.

The redesign of the Euro Area along these lines would not be an easy task. Political objections would be numerous to both their basic tenets and their specific structure and features. They would be raised by governments and other public institutions of many countries – such as the Bundesbank - and political parties. Recently, however, timid openings for a change of the current structure have emerged. These are contained in the documents, speeches and declarations of the representatives of the ECB and the new European Commission (Juncker Plan) as well as in the practical implementation of innovative policies, as in the case of unconventional monetary policies and a banking union. Most likely, the necessity of the reforms outlined above could be more widely recognized if reforms were diluted through time and a rather long path to their final realization was devised. This implies that their main body would be implemented only with the next generation or two. However, it would be important to realize their need and agree on a timetable right now.

4.2. A common growth strategy instead of competitive strategies

Possibly, one of the main implications of the analysis in section 2 is the need to reverse the previous trend of the different and often conflicting strategies of member countries, by adopting a common strategy of growth.

The dual strategy pursued by core and peripheral countries since the beginning of the Monetary Union exerted a negative influence on imbalances and implied low growth and the possibility of crises in the Union as a whole. To avoid these negative effects a strategy of reconstruction and redesign of the Euro Area institutions should be devised from a short-term, medium-term and long-term perspective.

In the short run, the issue is to prevent a new financial crisis and stabilize peripheral economies. This requires a mechanism like the one suggested by Bofinger (2016) and others. The mechanisms provided by the ECB might be insufficient to this end in the event of insolvency of a (rather) big country. Common policies of relief, in particular directed at the financial sector, together with its regulation, are required.

In the medium term, internal imbalances in both the current account and the public sector should be reduced. As to the current account, the MIB should be amended, by making imbalances symmetric and reducing their size. All policies on the side of costs and demand not shared with other member countries that trigger current account surpluses for one country are beggar-thy-neighbor and should then be avoided, also because the associated capital account surpluses impress a short-run expansionary impulse to other countries, leading to bubbles and distortions in the structure of production. Rebalancing can indeed take place through either inflation and expansion of demand in the former or deflation and contraction in the latter or both. This would have different implications on unemployment, which would rise in the case of the deflation of wages and prices in the periphery, whereas it would shrink with expansionary policies in the core. On the rebalancing consequences of expansionary policies in Germany see Horn and Watt (2017) and Horn et al. (2017).

Expansion by Germany and other surplus countries might imply a public deficit and an increase in its public debt, but would allow a reduction in the deficit and public debt of other countries. The rise could also benefit Germany. In addition, a cut in demand in peripheral countries usually implies a cut in public investment, which worsens the gap in the productivity trend between the core and the periphery. It should then be avoided. The action to enact would instead be, on the one hand, to force surplus countries to expand their budget and, on the other, to introduce a golden rule for public budgets, allowing for a rise of productive public investment.

The issue of outstanding debt should be faced in the medium-long run through a redefinition of the EMU institutions and policies based on different goals and attitudes of monetary and fiscal policy. In the long-term, a new strategy should be implemented, based on a common program of investment and growth. However, this should be devised – or, at last, outlined - soon, in order to inspire short- and medium-run interventions, recognizing that “social investment can promote demand in a manner that sustains rather than drains the private sector” (Garofoli and Holland, 2017, p. 4).

The common growth strategy could be supported by Eurobonds, an initiative usually ascribed to Jacques Delors - i.e., issuance of ‘Union Bonds’ to finance infrastructure investment. In practice, in November 2012 a framework for the issuance of ‘Project bonds’ was approved. These are a financial instrument launched by the European Commission and the European Investment Bank as an innovative response to the needs for investment in large EU infrastructure projects, as a part of the Europe 2020 Project. Moreover, the EU Commission has suggested some guidelines for the introduction of ‘Stability Eurobonds’ that could reduce and share the default risk. But, the way ahead is still very long.

5. Questioning German hegemony: for a democratic EMU

The only (formal) sanction available to Germany in the 1990s was not to agree to the establishment of EMU and to stay outside. In McNamara’s (1998) terms, German influence did not translate into monetary dominance, as Germany was not a hegemonic leader in the traditional sense either during the EMS period or afterwards. In a similar way, Dyson (1994) claims that the European integration process was certainly the product of the will and positions of the central actors involved, but this was shaped only as a set of interlinked bargaining relations, interacting with some key rules of the game, accounting for the `fundamentals’ of each country. In any case, in his opinion there was no hegemonic actor in the Euro Area design.

This position has scarce foundations, for numerous reasons. More than exercising leadership, the position of Germany tended to affirm its authority or even dominance over regional agreements like the EMS and, later, the Union. Kaelberer (2001) underlines the bargaining power of Germany over the rules of monetary cooperation due to its strong currency and, thus, absence of a reserve constraint. Other authors recognize that, during the EMS, the Bundesbank had imposed its monetary discipline, which caused two effects: a positive one, as it ensured disinflation in Europe; a negative one tied to the double-digit unemployment rate experienced by other European countries and the low growth rate of the whole area (Wyplosz, 1997). There are many reasons to say that this, together with other creditor nations, called the shots in European economic policy. Rejection of the Werner Plan of the early 1970s and acceptance of the

typical German pretense of having economic convergence before monetary unification (instead of conceiving this as the first step towards a more complete union) argue in favour of some kind of hegemonic position of Germany. In addition, one should also consider that in progress this role of Germany strengthened, in parallel with the stronger bargaining power acquired after re-unification. And this country made use of its position to be granted privileges when asking for exemptions for the violation of the SGP rules in 2003-2004, setting new institutional rules and deciding current policies. "By breaking the rules of the SGP, France and Germany left the impression that they are free of sharing the adjustment burden, and that EMU was wanting in leadership and solidarity," (Sadeh, 2005, p. 1675*)*.[4] In truth, the hegemonic position of Germany remained hidden, as this country preferred to remain backstage. According to Paterson (2011, p. 66), "it was argued that an exposed leadership position would be unacceptable to other members given the history of the past century". The hegemonic role of Germany had to become manifest only after the eruption of the crisis, which 'touched on (its) elemental material interests'. Germany's transition to a 'reluctant hegemon' position thus reached the tipping point.[5] In the most indulgent interpretation of the German 'vision' underlying the EMU construction, a common currency could integrate European economies and make them converge in due time: monetary unification could ensure the structural changes necessary for creating a stable macroeconomic context (in particular, uniform wage and price dynamics), while ensuring a looser monetary regime and allowing for German reflation.[6] Other, less favourable, interpretations are, however, possible. One of them could simply be that Germany intended to establish an institutional architecture stronger and tougher than that of the EMS that should have permitted it to pursue the goals of a mercantilist monetarism and to further the interests of its savers and the banking industry or, at least, that it did at some point actually exploit the agreed institutional set up to pursue such a strategy.[7] As to institutions, in order to preserve its veto power for key future decisions, in facing new problems of common interests, Germany tended to prefer intergovernmental agreements to higher supranational powers for the EMU (Webber, 2011, p. 20). In any case, its export-led model of growth made it unaffected – or little affected - by the deflationary bias of the EMU. At the same time, the specular image of its export surplus, i.e. its nature of a creditor country, empowered it with deciding the solutions for the crisis more suitable to pursue its interests (Webber, 2011). Germany must certainly be credited to have been able to create a system powerful enough not to suffer from the deflationary bias of the EMU institutions, due to the real devaluation it operated since the 1990s, in particular in the early 2000s, and for its ability to build a successful system to compete in Europe (and to some extent outside the area) through the quality of its products. However, these very credits constitute acts of distrust towards the construction of a true common institution. Germany might have some justifications for that in the inactivity of peripheral economies, but not before 2003-2004.

As to the construction of a true democratic Union, an important preliminary clarification is needed about the meaning of the term 'democratic' institution. Democracy can be seen from a 'collective' or an 'egalitarian' perspective. The former emphasizes the possibility for a people – in this case, the Euro Area constituency - to elect its governing institutions. The latter is less demanding, as it preserves self-government of countries, but also suggests integration of policies and accountability of international institutions (Eleftheriadis, 2014). According to Eleftheriadis, the EU is only a union of people, which can become more democratic, even if it cannot become a democracy. If in the short run we can accept this position, it must be said that the dream of the founding fathers of Europe tended certainly more to the goal of a European people. This dream can require time, but it is important to have in mind some kind of path that can lead to its implementation.

[4] On this see Sinn (2003).

[5] On the opportunities and risks deriving from this position see Bolaffi and Ciocca (2017).

[6] However, this interpretation would run counter to the pretense of having some kind of economic convergence before unification, which was certainly the Bundesbank position (Wyplosz, 1997).

[7] Steinberg et al. (2016, p. 2) indicate four clusters of domestic societal interests in Germany, "deeply rooted in the institutional structure of its co-ordinated market economy: trade interests of the export-oriented sectors; fiscal interests of its taxpayers; monetary interests of the Bundesbank; and financial interests of the banking industry." We can add to these the interests of savers, which have become manifest more recently, due to their opposition to the ECB policy of low interest rates aimed at offering a relief from deflation.

The EU Commission has introduced a system of contacts with various stakeholders, trying to develop a method of consensus. However, this has involved mainly the élites and has not ensured the necessary transparency (Newman, 2006). Majone (2014) speaks of a kind of 'democratic default' in the Union, which arose over time, starting with the failure of the CAP, continuing with that of the Lisbon Strategy and ending with the misconduct in the prevention of, and response to, the financial crisis. Then the issue arises of how to combine democracy with other requirements of a heterogeneous Europe and the different positions and abilities of each country. Only from solutions respecting all these requirements can a viable and democratic Europe spring (Featherstone, 2016).

In any case, democracy would require less involvement in policy decisions and in the ability to punish by unelected people, such as those governing the EU Commission and the ECB, and markets (De Grauwe, 2011) as well as less hegemonic positions by any country. According to Schelkle (2006), this raises issues of democracy. In fact, against the position that has led to keeping politicization out there are good arguments in favour of bringing politics back in, as this would "halt growing apathy or outright hostility towards the emerging European polity" (Schelkle, 2006, p. 681) or, at least, contribute to that. Schelkle's reasoning seems to be even more relevant facing growing populism in European countries. To overcome apathy and populism also more transparency of the process leading to decisions is needed.

Some kind of 'deliberative supranationalism' (at least in the transitional phase before a federation or the goal of a European people can be established) would be required also in order to face conflicts between countries. In fact, both country and sectional (often conflicting) interests play now a relevant role in EU governance. As to the latter, policymakers' personal preferences or the sectoral interests influencing them fill in the space between input participation by the people and output, in terms of policy effects in favour of people. This can be hindered by people's participation in governance, which can ensure transparency, accountability and inclusiveness, thus contributing to a better outcome. However, in the words of Nicoli (2017, p. 399), the EU misses the necessary 'convergence of identities'.

This generates a number of problems of governance in the Euro Area, which are at the root of the pains related to the crisis. In a nutshell, the missing 'convergence of identities' makes it difficult to build a federal entity and, almost as a reflection of this in the Union a series of partial powers exist that are often attributed to unelected institutions or are often blocked by veto powers. As to country interests, one case may be of particular significance: "while EMU's domestic demand-led models are forced to pursue painful austerity measures that have reduced inflation and increased unemployment, no attempt has been made to correct the excessive levels of wage moderation in the EMU north, specifically Germany, which undermined the periphery's lack of competitiveness in the euro's first decade. The result of the EU's policy response, which has been shaped in the shadow of German hierarchy, has been to establish an asymmetric low-growth equilibrium within Europe that exclusively penalizes its southern rim" (Johnston and Regan, 2016, p. 333).

The different size of countries and the asymmetry of power between 'creditor' and 'debtor' countries in the management of the Euro Area crisis and the ongoing institutional reform process of the EMU have brought the issue of German dominance in Europe back to the forefront of scholarly debate. Germany has pursued the interests of its savers by shifting the burden of adjustment deriving from the financial crisis on debtor countries, as is clear from the policies imposed on Greece. However, at least on this occasion, France and Italy have shared the same attitude. Likewise, in the case of the ECB policies to relieve the Euro Area from the ensuing recession, the Bundesbank and, to some extent, the German government have pushed against unconventional policies, expansionary fiscal policy and rising inflation, in order to protect the interests of German savers. In this circumstance, the ECB has taken a firm position, favoured by its independence. However, this situation is no longer tolerable and a more balanced governance should be implemented. Creating a common finance minister for the whole Euro Area could to some extent increase the coordination of macroeconomic policies, while raising other institutional issues. Alternatively, a Fiscal Council could be charged with the task (see more in Pisani-Ferry, 2014).

Some steps for pursuing economic and political goals over the next years are indicated in the paper recently prepared by the EU Commission (European Commission, 2017). It covers issues such as banking and capital markets unification, economic and social convergence, preparation of the new Multiannual

financial framework, the fiscal stabilization function, in addition to those of democratic accountability and effective governance.[8] There are different projects for the periods 2017-2019 and 2020-2025.

The democratic deficit of the EU should properly be fixed. The situation could be improved by implementing some minimal rules, such as more transparency concerning the motivations and effects of decisions, with specific reference to the categories of people that would benefit and those that would be hit. A range of reforms oscillate between a minimalist and a maximalist perspective. To exemplify, let us refer first to governing bodies. The European Commission could be elected either indirectly via the European Parliament or directly by EU citizens. As to the ECB, in confirming its independence one can think of subjecting it to oversight, either by the EU Parliament and the EuroGroup and/or also by national parliaments of member countries. Finally, bailout funds and austerity programs can be subject to approval and scrutiny by national parliaments or referendums ratifying them.

A solution to the democratic deficit would require not only a change in the orientation and the modes of current decisions, but also and mainly a radical change in the institutional setting of the EMU (Pisani-Ferry, 2014). This would be difficult to implement in the absence of a process of re-envisioning of the socio-economic policy.

A democratic state must respect the will of its citizens, but also be efficient. From this point of view, a number of reforms of the Euro Area are in order.[9] From a methodologic point of view, a starting point is offered by existing institutions, in the process of changing them in the directions we have traced. Key elements can reinvigorate the Broad Economic Policy Guidelines and the framework that guides economic policy. Horn and Watt (2017) suggest also to extend the EU Macroeconomic Dialogue, in particular by setting up meetings at Euro Area level, by involving the Eurogroup, the peak European social partner organisations, and – at the level of Member States - the participation of national central banks, fiscal authorities and national social partners.

6. Is exit an option?

The difficulties in building the Euro-zone with the contribution of countries having different institutions and histories – better to say, countries that had been engaged in some cases in ferocious conflicts and wars – have been enormous. These differences certainly had an influence on the attempts to cope with the crisis. The different course of the crisis in the various countries, with a high price paid by the periphery in terms of GDP, employment and debt burden, has implied understandable requests of exit from the Euro-area, in particular in peripheral countries. But doubts have also been raised as to its benefits and costs mainly with reference to the effects of exit on competitiveness and the path that would follow from exit, given some crucial features of the economies of peripheral countries. We deal with both in turn.[10]

Exit is advocated with many justifications. First, it has been argued that the economic advantages from participation in the monetary union have been meagre (Dreyer and Schmid, 2016). Some authors have noted a negative impact of the financial crisis on the members of the Eurozone, due to fixed exchange rates, which tend to accentuate the negative effects of the crisis (Bohl et al. 2016). In exiting, a country would regain control over monetary and fiscal policy and be freed of the constraints on their use deriving from the reduced inflation target, the SGP and the fiscal compact limiting it when being a member of the EMU. It would thus have the possibility to cope with asymmetric shocks and its specific problems, such as a high debt burden. In addition, by exiting it would (re)gain control also of the exchange rate as a way to improve its competitiveness. Countries no longer tied to the euro would adopt a flexible or fixed (but adjustable) exchange rate, allowing for a depreciation or a devaluation of their new currency (Feldstein,

[8] On the need for economic convergence we must be clear. There are a number of reasons supporting this need; the most important one has to do with the imbalances deriving from asymmetries and divergencies.

[9] For details on them we refer to Acocella (2018), from which we have drawn many parts of this paper.

[10] These are different according to whether there is a 'disorderly' or an 'orderly' and consensual exit. While this distinction is important, for reasons of brevity we do not go into detail and address the reader to Meyer (2012) for an in-depth discussion.

2012).[11] In fact, an increase in competitiveness would ensue, and the country would bridge the gap with Germany, which enjoys an advantage deriving from the undervaluation of its real exchange rate – of the order of about 20-24 per cent with respect to Italy (Sapir, 2017).[12] According to this author, there is no other alternative open to France, Italy and Spain and permanence in the EMU would mean the death of the economy, due to impoverishment and deindustrialization. Bagnai et al.'s (2017) stochastic simulations show that, after some initial stress in terms of their balance of payments, appropriate countercyclical policy measures could make growth of Italy to resume in five years' time, 'at a reasonable pace', with lower unemployment and a reduced public debt-to-GDP ratio.

Critics of exit remark that the relief deriving from exit would be of short duration, as the external depreciation would fuel wage and price inflation. The inflationary process could be so high as to have a negative impact on distribution and social cohesion, as happened in the past when national currencies were either tied by adjustable fixed exchange rates or not pegged at all as an effect of some international agreement (e.g., the EMS, especially before 1985-1987 and after 1992, for the Italian lira).[13] Moreover, Eichengreen (2010) notes that a country would experience a significant rise in interest rate spreads and debt-servicing costs as an effect of its departure from the EA. The public and private debt that are euro-denominated would increase in terms of the new local currency. Credits towards foreigners could instead appreciate. If the *lex monetae* – whereby a sovereign state can decide the currency of denomination of its debts - is called into question, there will be no such appreciation, unless the Collective Action Clause is to be applied, which is the case for the majority of government bonds, as from 2017 onwards. In 2022 almost all these bonds will be under a Collective Action Clause (whereas almost none were at the end of 2013), which would imply a net loss of €381bn, assuming a 30% devaluation of the new currency.

Going to the path that peripheral economies would follow for exit, one may first ask whether exit is the real target to pursue, given a positive balance of its benefits vs. costs, or whether it is simply a threat to other countries directed at pursuing some other benefit through some kind of concession. If the latter is the case, the threat, even if not desired per se, should be credible. This requires in any case a favourable review of benefits and costs. In addition, exit should be carefully prepared. Many authors have noticed that it could be particularly disruptive, as speculative capital outflows would arise even before exit, due to expectations (Dobbs and Spence, 2012). This can even happen, when simple fears of exit – not followed by it - arise in a country, as happened after 2010. Bank failures could follow from capital outflows. Certainly, capital controls (notably, under the form of taxes on foreign capital) could be implemented, but one can doubt of their effectiveness when adopted by countries having an inefficient public administration and in an era where electronic money and transfers are available. In any case, capital control not only has direct effects (i.e., those due to taxes), but also indirect effects that influence investors by signaling the likelihood of future policies, especially action that will negatively affect their investment (Forbes et al., 2016).[14]

The need to keep plans for exit secret would thus arise and this way of implementing exit is advocated by many authors. However, it seems difficult to do this, not only for technical and political problems. The latter, in effect, invest issues of democracy and acceptance of the potential losses accruing in the first years after exit. These needs must be balanced against the need to raise the bargaining power of peripheral countries. In fact, core countries are certainly sensitive to the prospect of these countries threatening their competitiveness.

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[11] Obviously, in the event of exit of a hard-currency country, the problems could be opposite. This prospect is investigated by Meyer (2012).

[12] The order of magnitude of devaluation is debated, as some authors think that it can be rather low (Durand and Villemot, 2016), while others hold that it can reach a peak of 60 per cent, at least at the beginning (Minenna, 2016). Obviously, it depends on a number of factors referred to the country involved, such as its financial and real exchanges reserves as well as the degree of overvaluation of its real exchange rate with respect to the rest of the EMU, the secrecy of preparation of exit and the time required for the new payment system to be implemented.

[13] In the case of Italy, it was only the extreme cooperative attitude of social partners that allowed putting a halt to depreciation.

[14] These conclusions refer to cases of capital controls in a different political and economic environment like that of Brazil's tax on capital inflows implemented from 2006 to 2013. Thus, they can only be indicative of some indirect effects of such measures that are not easy to devise and assess.

7. Conclusions: A federalist union?

As said, exit – or at least the threat of exit - is certainly an option, even if it is difficult to pursue. It is one of the main avenues indicating a long-term perspective. At the opposite end there is a prospect of construction of a federal state. According to Belke (2016, p. 150), the way towards a sustainable "Economic Governance of the Eurozone and the EU can only lead via a consistent fiscal federalism combined with an incentive-compatible Banking Union". In addition, there is Pisani-Ferry's (2012) 'trilemma', deriving from the association of three features of current EMU institutions, i.e. strict non-monetary financing, the national character of banking systems and no co-responsibility for public debt. Different policy solutions are available to avoid the trilemma. Each of them implies abandoning one of the three tenets of the EMU institutions, in favour of a broader ECB mandate allowing for either monetary financing of governments, or a banking federation, or a fiscal union with the possibility of issuing common bonds. A recent contribution applying a well-known New Keynesian micro-founded model has confirmed the advantages of fiscal unions having various federal revenues and transfers in terms of risk sharing in providing macroeconomic stabilization across countries (Farhi and Werning, 2017). Fiscal integration is one of the suggestions contained in a study within the IMF (Allard et al., 2013), together with a system of fiscal risk sharing by temporary transfers or joint provision of common public goods by a centralized budget. In addition, these proposals are not easy to implement. Possibly, two solutions are more feasible: first, implementing the common deposit insurance or some kind of common resolution mechanism for banks; second, taking some steps in the way to a federal fiscal policy, such as increasing the level of the EU budget. Both could help to rebuild trust in the Union. But the obstacles they meet are quite the same. In fact, both would require raising revenues at the EU level and the size of the EU budget, which is in contrast with the route followed after 2013. Timid steps in this direction are contained in the Five Presidents' Report of June 2015 (Juncker et al. 2015) and the Reflection Papers on the Deepening of the Economic and Monetary Union and the Future of EU Finances of spring 2017.

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