ANALYSIS

ECONOMY AND FINANCE

CRISIS AND REFORM OF THE EURO ZONE. WHY DO WE DISAGREE?

A reflection paper on the North–South divide

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There is general agreement that reforms of the euro-zone architecture are necessary, ideally aimed at fostering further integration on the grounds of (at least) economic policy and governance.

The narrative of the crisis is decisive. Suspicion runs high and mutual trust runs low between the southern and the northern European euro-zone countries. And neither the northern euro-zone countries nor the southern euro-zone countries can account for the full story of the euro zone's malaise, not to mention possible ways out.

Better rules are not enough, new common institutions are necessary. Reform of the euro zone should be based on a confederal and cooperative model.

FRIEDRICH EBERT STIFTUNG

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Summary

There is now general agreement among international scholars, authorities and even political leaders that reforms of the euro-zone architecture are necessary, ideally aimed at fostering **further integration** on the grounds of (among other things) economic policy and governance. This claim has also been endorsed by the top European institutions. The Juncker Commission has taken the lead on the reform agenda and the new Commission has endorsed a number of proposals.

Behind this general plea for ›more Europe‹, however, divergences loom large. The cleavage is normally represented geographically, with northern euro-zone countries (NEZ) on one side, the southern euro-zone countries (SEZ) on the other. Our reflections ›from the South‹ reflect this, although it is quite clear that the divergences have more to do with the economy and politics than with geography. In fact, suspicion runs high and mutual trust runs low between the northern euro-zone countries and the southern euro-zone countries. In these circumstances it is extremely difficult to reform the euro zone's rules and institutions, while current conditions seem to favour populist, ›sovreignist‹ and anti-EU movements. The very existence of the euro zone and of the EU are in jeopardy.

The aim of this paper is twofold. We first attempt to **understand the crisis and its mismanagement** by appealing to a ›consensus view‹ that emerged progressively, mainly around ›mainstream‹ economic principles. Admittedly, these are not referred to as such by ›hardliners‹ in the northern euro-zone countries or in the southern euro-zone countries. This effort will help the reader to focus on why we disagree and to find out whether and how we can agree. Second, we try to build on this common narrative in order to **identify possible consensus changes in the euro-zone rules and institutions**.

The narrative of the crisis is divisive because, while there is broad agreement regarding the list of the ingredients of the crisis, the narrative prevailing in the NEZ downplays the dimension of institutional mismanagement of the crisis to emphasise the responsibilities of single countries (notably the SEZ, due to their fiscal indiscipline and loss of competitiveness) whereas dominant in the SEZ countries is the inverse causal ranking.

Our take from the consensus view is that **the crisis originated in the United States** and spread across the world, but indeed there was a dramatic **›Europeanisation‹** – mainly through private financial channels – which was exacerbated and prolonged by the **interaction among flaws** inherent in euro-zone governance and in structural factors in both the northern and southern euro-zone countries. These factors specific to different countries were also the cause of their different responses in the course of the crisis.

Was the crisis mismanaged? Was this responsible for its deepening? Are there lessons to be learned? These questions, too, are matter of north/south disagreement, whereas we highlight three points of convergence among international observers, namely that **fiscal austerity was too early, too large and uncoordinated.** The result was a pro-cyclical and counter-productive fiscal consolidation that led to a second recession after 2011 and an increase in the debt-to-GDP ratio in countries in which austerity measures were implemented more harshly. **The absence of common financial backstops** paved the way for public involvement in private turmoil, as well as fears of insolvency among highly indebted sovereigns and the rise of redenomination risks. **The ECB was left alone in fighting the crisis,** while it is well known that monetary policy and fiscal policy should be coordinated.

Consequently, while it is often said that the only way out of the present euro-zone maze is ›more Europe‹, **there are also two different ›more Europe‹ reform models**. One is the **Maastricht 2.0 model,** which seems more akin to the northern euro-zone countries, whereby the doctrine of exclusive national responsibility is reaffirmed, the Fiscal Compact is elevated to the rank of EU legislation and further sovereignty is devolved to supranational technocratic agencies with a clear mandate to enforce the rules vis-à-vis national governments. In this model, market discipline has a prominent role, while risk sharing is strictly subject to previous risk reduction on the part of financial institutions and sovereigns.

The problem is that implementation of the Maastricht 2.0 model would not solve the euro-zone problems brought to the fore by the crisis, besides hardly being acceptable to the southern euro-zone countries. An alternative we put forward is the **Confederal and cooperative model** on which both the southern and northern euro-zone countries might agree.

This model is based on the premise that better rules are not enough, **new common institutions are necessary.** Key to overcoming the mistrust that permeates the euro-zone reform process is finding the right institutional model within which the reformed euro zone should be framed. This, in our view, should consist of a supranational upgrade towards **sovereignty sharing.** That is, neither further sovereignty devolution to technical entities that are supposed to enforce rules mechanically, nor extensions of the disorderly intergovernmental approach that seized the helm during the crisis. Instead, the pursuit of cooperative policies and controlled discretion need political control on the part of a genuine supranational policymaking institution with transparent democratic legitimacy.

Within this new institutional setup, all countries should subscribe to the position that:

(i) euro-zone members can only be **united in diversity;** there is no one-size model of the economy and society that fits all, nor can it be forced top-down;

(ii) a monetary union needs a **commitment to fiscal discipline:** debts should be under control and reduction must take place where and when necessary; no new structural current expenditure should be permanently debt-financed;

(iii) to this end, **fiscal rules are needed,** although to be sure, simple, transparent and counter-cyclical fiscal rules;

(iv) **rules are aimed at disciplining discretion,** not suppressing it entirely (which is impossible anyway in the governance of a complex, evolving system);

(v) **common tools for macroeconomic stabilisation and growth** are necessary because our economies, and societies, are interconnected, and pretending the contrary is nonsense; hence a **true and serious common budget** is also necessary;

(vi) **private–public financial stability** needs risk sharing (a request of the southern euro-zone countries); in turn, risk sharing should proceed with risk reduction (which is what the northern euro-zone countries wants).

Genuine reformers will need the credible determination to present all other players with a clear-cut alternative: either a serious reform is begun here and now, with all the necessary ingredients – some that the South dislikes and some that the North dislikes – or everyone will have to take their own share of responsibility for saying ›no‹ to a genuine and sustainable European Economic and Monetary Union.

1

INTRODUCTION

It is a truth universally acknowledged that, after the 2008 financial crisis, the euro zone performed poorly compared with non-euro-zone EU countries or other comparable areas, such as the United States. It is not the euro as such that should be blamed. In the period 1999–2007 the economic performance of the single currency area was close to that of non-euro-zone EU countries or of the United States. The euro zone's foundations were seriously shaken by the first stress test in its (short) history, namely the global economic and financial crisis that exploded in 2008. This was a storm that Europe initially contemplated from a distance as an American affair, but soon rained down on our continent with greater force and for a longer time. In 2014, the distinguished European economist Charles Wyplosz published a paper that epitomised the growing discontent with the way in which the euro zone was managing the crisis, with the harsh title: ›The Eurozone Crisis: A Near-Perfect Case of Mismanagement‹. ›The Eurozone crisis occurred‹, he wrote, ›because the institutional setup was imperfect‹ (p.12). However, the agreement does not reach far beyond that. Interpretations and narratives of the crisis and of the policy reactions to the crisis differ in the northern and in the southern euro-zone countries. Consequently, disagreements are also prominent with regard to applicable cures. Many observers and political leaders seem to be happy to agree to disagree. Trust is lacking between northern and southern euro-zone countries to the extent that the euro project is recurrently being undermined and the risk of some countries' exiting (and the likely contagion effect) is felt to be around the corner.

There is also a widespread feeling that northern euro-zone public opinion is not correctly informed about the different views on the euro-zone crisis and reform – most of which, by the way, come from the mainstream Anglo-American academia – whereas they are presented as if they were the Trojan Horse of obscure interests in the southern euro-zone countries. The popular press in the South reciprocates, blaming the euro and the northern euro-zone countries (Germany in first place) for putting their economies on their knees. Is there a tendency to bend (or ›cherry pick‹) economic principles in support of national views and interests? If the answer is ›yes‹, a second question arises: are we able to find a common description of the present shortcomings and needs of the euro zone and, based on this, to reach a reasonable agreement between North and South on a minimal set of reforms aimed at safeguarding and strengthening the euro zone?

The aim of this paper is twofold. We first outline a narrative of the crisis and of its mismanagement by appealing to a ›consensus view‹ that emerged progressively, mainly around mainstream economic principles, which, admittedly, are not specifically referred to by Northern or Southern hardliners. This effort will help the reader to focus on why we disagree and to find out whether and how we can agree. Second, we try to build on this common narrative in order to identify the possible consensus changes in the euro-zone rules and institutions.

Mistrust is, in our view, the chronic disease that is crippling euro-zone reforms and may even pave the way to its eventual collapse. Indeed, there are reasons for *reciprocal* mistrust that should be taken seriously *on both sides*. We argue that a Maastricht 2.0 approach (more and stricter rules, more »home-works«, more room for intergovernmental methods, supplemented by technocratic agencies) would be the wrong solution. It may enlarge the gulf between Europe (and the euro) and national public opinion, which believes that once-and-for-all rules may be against its interests. A more communitarian or Confederal approach, alongside strong national responsibilities is to be preferred. Some of the necessary reforms have already been (albeit only partly) designed in the Five President Report (2015), in the Franco-German Meseberg Agreements (19.06.2018), in the Autumn 2018Eurogroup meeting and in the *Assessment of EU Fiscal Rules* recently released by European Fiscal Board (2019). However, we do not share the view underlying many of the mentioned proposals that sovereignty should be devolved in favour of purely technocratic institutions. Such a move would hardly be endorsed by northern or southern public opinion.

To overcome mistrust, **a common step towards sovereignty sharing** is necessary. That is to say, **new rules and new cooperative policies should be envisaged** vis-à-vis political control that should be retained and exerted by (representative of) national governments. We are aware that many stumbling blocks stand in the way. We are also aware that reforming the euro zone is not going to be easy. As in any ›high politics‹ operation, a unique combination of vision, determination and brinkmanship is needed. Business as usual would just be one more *ascenseur pour l'échafaud* of for the euro area and the whole of Europe.

2

ABOUT NORTH AND SOUTH

There is little reciprocal knowledge in Europe in general. Not only among peoples, which may be understandable, but different languages, different cultures and different media all make for suspicion and low reciprocal trust. We see a lot of approximation, prejudice and stereotypes even in the press, opinion makers, politicians and scholars. This is harmful and not excusable. We shall start from a few notes on the North–South divide in the euro zone.

There is an obvious geographical distinction between North and South, but it is clear that the North–South divide of the euro zone has more to do with economic and political cleavages than with geography. The South of France has a lower latitude than the North of Italy and of most of Portugal. Slovenia has more or less the same latitude as of Northern Italy, but is closer to Austria under many respects. Ireland is geographically North, but it was associated with the infamous GIPSI group (to be identified with the southern euro-zone countries) in the early post-financial crisis years. For reasons to be made clear shortly, we shall consider France and Ireland as neither North or South. We include Portugal, Spain, Italy, Greece and Cyprus, Malta in the South of the euro zone and the Netherlands, Belgium, Luxembourg, Germany, Austria, Estonia, Latvia, Lithuania, Slovakia and Slovenia in the North (see **Figure 1**).

The southern euro-zone countries, with a population of 129million, are not a homogeneous area. Political and cul-

Figure 1
Geopolitical-economic map of the north (red) and the south (orange) of the euro zone

tural diversity are apparent. Also structural economic features vary widely. Italy is the second-ranking manufacturing and exporting country in Europe. Its current account balance has usually been positive and has never breached the 4per cent deficit over GDP established by the Macroeconomic Imbalances Procedure. Other southern euro-zone countries have weaker manufacturing and exports. Northern Italian regions are closer to southern Germany than to their southern euro-zone fellows with regard to per capita GDP, productivity and industrial specialisation. The value-chain integration between some North Italian and South German manufacturing firms should also be stressed.

One may detect some common southern patterns in the banking system: in all southern euro-zone countries industrial firms are more dependent on banks than on financial markets; in most of them, banks' non-performing loans (NPL) have increased as a consequence of economic stagnation/decline. However, the elasticity of the NPL ratio with regard to GDP appears higher in Italy, Greece and Cyprus than in Portugal or Spain.

On the other hand, Italy, more than other southern euro-zone countries, has long been affected (especially in the 1980s and early 2000s) by soft budget constraint syndrome and is now overburdened by a high-debt legacy.

The northern euro-zone countries (population 140million) also constitute a non-homogeneous area. In large part, it consists of ›small countries‹ in the economic orbit of Germany (Finland, Slovakia, Slovenia, Latvia, Lithuania, Estonia, Luxembourg). Estonia, Finland, Latvia, Lithuania and the Netherlands (together with Sweden, Denmark and Ireland) have recently presented themselves as an area of common political interests – referred to as the ›Hanseatic League‹ – regarding euro-zone reform. Economic integration with Germany is both a strength and a weakness of these countries (and the euro zone as whole), because they remain highly dependent on the German business cycle and world trade trends, as well as on the health of the German banking system.

Apart from size, and other aspects of economic development, a major difference across the northern euro-zone countries is that the small countries are not affected by regional dualism and wide income and standard of living disparities, in contrast to Germany (East–West) and Belgium (Flanders–Wallonia).[1] Regional dualism, as we shall see, is a critical factor, more important than usually believed, that the larger northern countries instead share with other large euro-zone members such as Italy, Spain and France.

It has become commonplace to include France in the North and Ireland in the GIPSI group. Together, these two countries have a population of 72million and present peculiar features that make it hard to include them in either the northern of the southern euro-zone countries. Ireland is the European platform for American ICT and web companies, now with the highest per-capita income in the euro zone (except Luxembourg), highly concentrated in Dublin. Ireland suffered dearly because of the financial crisis (and its public debt soared due to its approach to bank bailouts). Thanks to its peculiar position in the international division of labour, however, Ireland has proved to be highly resilient. Now the former GIPSI country belongs to the Hanseatic League, together with many northern euro-zone countries.

France had a higher per capita GDP than Germany up to 2005; the latter persistently lagged behind. France has had a deficit-to-GDP ratio higher than Italy's since the financial crisis, and is now the only euro-zone country with an external deficit. The debt-to-GDP ratio increased substantially, hovering just below 100per cent of GDP. However, France benefits from a very special political (consequently economic) status in the EU. Since the Second World War France has been given the political role of guarantor of Germany's full Europeanisation (to avoid the threat of some sort of ›German Europe‹). The possession of this political ›key‹ left France de facto with wider fiscal space and gifted it strong clout and brokering power that no other country may ever again dream of wielding in Europe. Plenty of evidence suggests that, politically, France thinks of itself as the hinge between the northern and the southern euro-zone countries.

1 The post-2008 increase in standard of living disparities across German regions is documented in Fink et al. (2019).

3

THE EUROPEAN CRISIS. A TALE OF SINS AND EXPIATION?

There is now general agreement among international scholars, authorities and even political leaders that reforms of the euro-zone architecture are necessary, ideally aimed at fostering **further integration** on the grounds of (at least) economic policy and governance. This claim has now been endorsed by the top European institutions: the Juncker Commission has taken the lead on the reform agenda[2] and the new Commission has endorsed a number of proposals.[3]

Behind this general plea for ›more Europe‹, however, divergences loom large because the northern and the southern euro-zone countries. We shall discuss the reform proposals in Section 8, but before that it is necessary to highlight that disagreement originates in different interpretations and narratives of the crisis. So much so that a team of distinguished economists felt it necessary to gather a ›consensus view‹ on the causes of the crisis, which was published in 2015 (eight years after the crisis: see Baldwin and Giavazzi (eds) 2015, and CEPR 2015 for a summary view). To be more specific, while there is broad agreement regarding the ingredients of the crisis, the prevailing narrative in the northern euro-zone countries downplays the dimension of institutional mismanagement to emphasise the responsibilities of individual countries (notably the southern euro-zone countries; see, for example, Sinn, 2014), whereas the inverse view of the causal ranking is dominant in the southern euro-zone countries.[4]

Our take from the consensus view is that **the crisis originated in the United States** and spread across the world, but indeed there was a dramatic **›Europeanisation‹** – mainly through private financial channels – which was exacerbated and prolonged by the **interaction among flaws** inherent in euro-zone governance and in structural factors in both the northern and southern euro-zone countries. These factors specific to different countries were also the cause of their different responses in the course of the crisis. Shifting the blame onto the southern euro-zone countries as scapegoats is misleading, however, and feeds demagogic propaganda on both sides of the Union.

3.1

To begin with, the macroeconomic performance of the euro zone as a whole, *and of the northern euro-zone countries,* compared with the rest of the advanced industrialised countries, or even European non-euro countries, has been poorer in many dimensions, even before, but most clearly after the global Great Recession.

Figure 2 depicts two main indicators of macroeconomic performance: the annual changes in real GDP, and its recovery rate from 2007 to 2015. For each indicator panel (a) compares the euro zone as a whole with other EU countries and the United States; panel (b) compares the euro zone as a whole with our geopolitical-economic sub-groups, namely the major four northern euro-zone countries (NEZ4: Austria, Belgium, Germany, Netherlands), the other seven ›small‹ northern euro-zone countries (NEZ7: Estonia, Finland, Latvia, Lithuania, Luxembourg, Slovakia, Slovenia), the four southern euro-zone countries without Greece (SEZ4: Cyprus, Italy, Portugal, Spain) and Greece. Note that the NEZ4 and the SEZ4 together form a large part of the euro zone, and of the North–South map (Greece has been kept out because of its exceptional recent experiences). As can be seen,

- the 2008–2009 world recession hit all countries with roughly the same shock, although the United States to a lesser extent than Europe (euro zone and non-euro zone EU countries), and the small NEZ7 to a greater extent than the rest of Europe; after the short global spring of 2010, some significant divergences took place;
- the euro zone started to lag behind the United States and the non-euro zone EU countries, and the SEZ4 lagged behind the rest of the euro zone;
- unlike the United States, the whole EU – and especially the euro zone – fell into double-dip recession in 2012;

2 As testified by the so-called ›Five Presidents' Report‹ in 2015, the *White Paper about the Future of the EU* in 2016, the *Reflection Paper on the Deepening of the Economic and Monetary Union* and the subsequent *Roadmap for Deepening the Economic and Monetary Union* in 2017.

3 Mission Letter to the Commissioner-designate for the Economy by the new President of the European Commission Ursula von der Leyen.

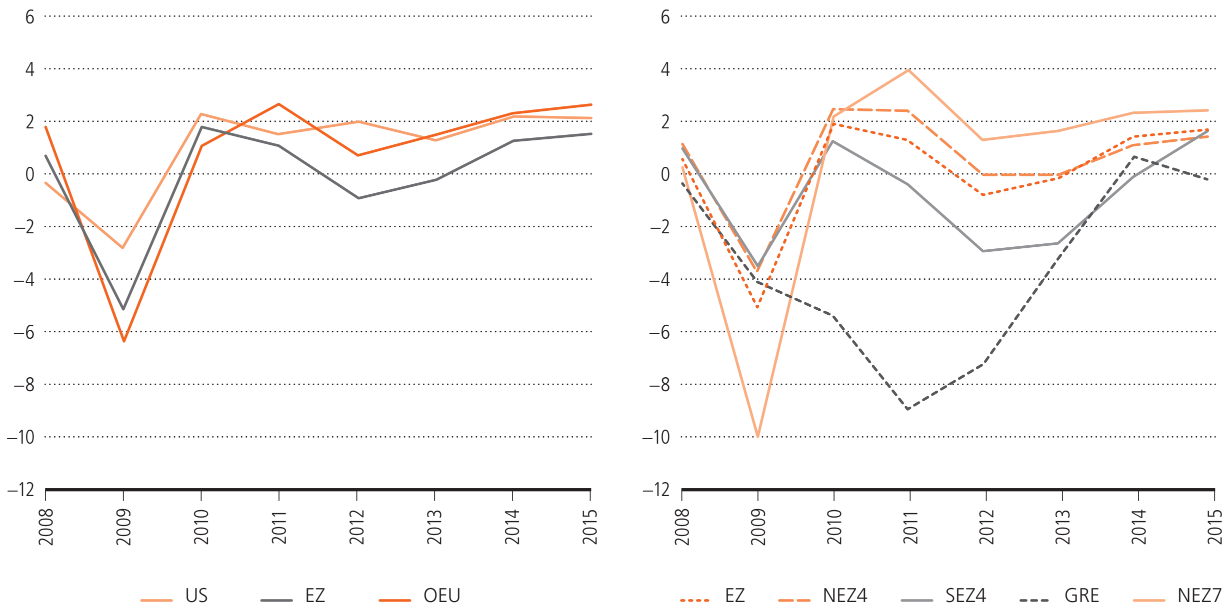
4 Not only in the southern euro-zone countries, in fact. In December 2015, Oxford Professor Simon Wren-Lewis wrote an outspoken article in *The Independent* entitled ›Who is responsible for the Eurozone crisis? The simple answer: Germany‹, in which he argued that the ›wrong economic model of the crisis led Germany to insist on tighter fiscal rules which created a second Eurozone recession. German influence on the European Central Bank also led it to delay QE for six years, and raise rates during 2011. Finally we saw how the actions taken much earlier by German employers and employees helped to protect Germany from the consequences of all this‹, basically by undercutting their euro-zone neighbours (on labour costs).

Figure 2
Macroeconomic performance, 2008–15

(a) % year change of real GDP, 2008–15

Euro zone, other EU and US

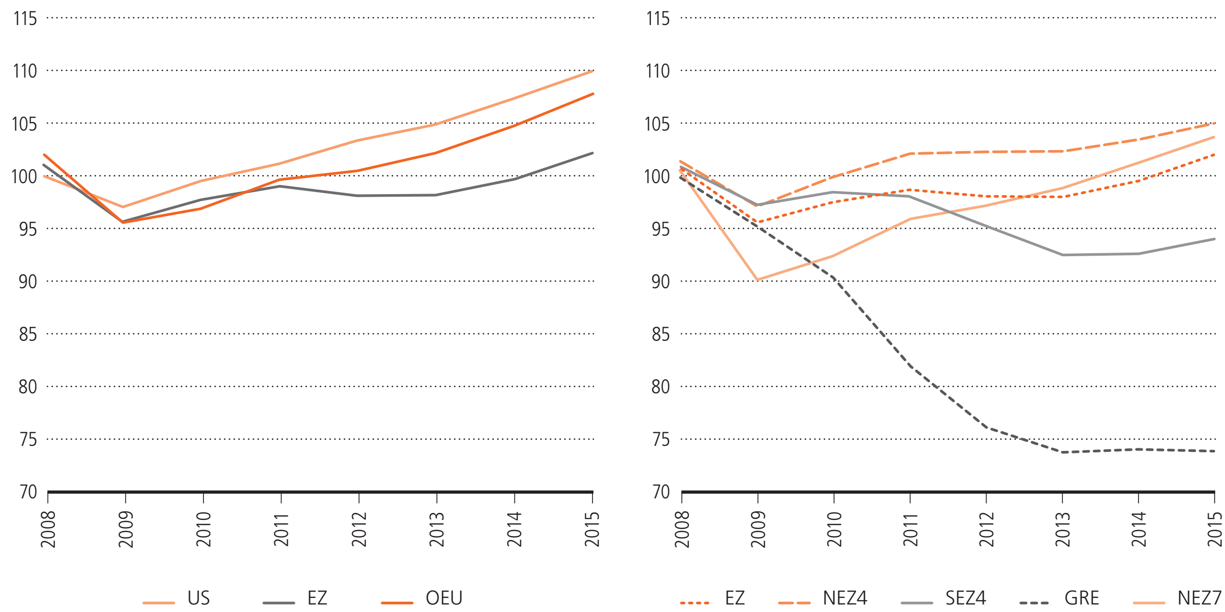
Euro zone and sub-groups



(b) Recovery of real GDP, 2007 = 100

Euro zone, Other EU and US

Euro zone and sub-groups



– recovery has been slower across the whole euro zone than in the non-euro zone EU countries and the United States, notably as a consequence of the double dip recession (the United States returned to 2007 GDP in 2011, the euro zone in 2015); from this point of view, we can observe a marked North–South divergence, with the SEZ4 (let alone Greece) on the slowest path of recovery, but also that the northern euro-zone countries altogether did not catch up with the non-euro zone EU countries or, of course, the United States.

The same pattern holds for unemployment, Germany being the single ›outlier‹ with remarkably stable employment. Although very preliminary, this evidence suggests, as already mentioned, **a specific malfunctioning of the euro zone,** as well as specific dysfunctional factors affecting **both the northern and southern euro-zone countries**.

3.2

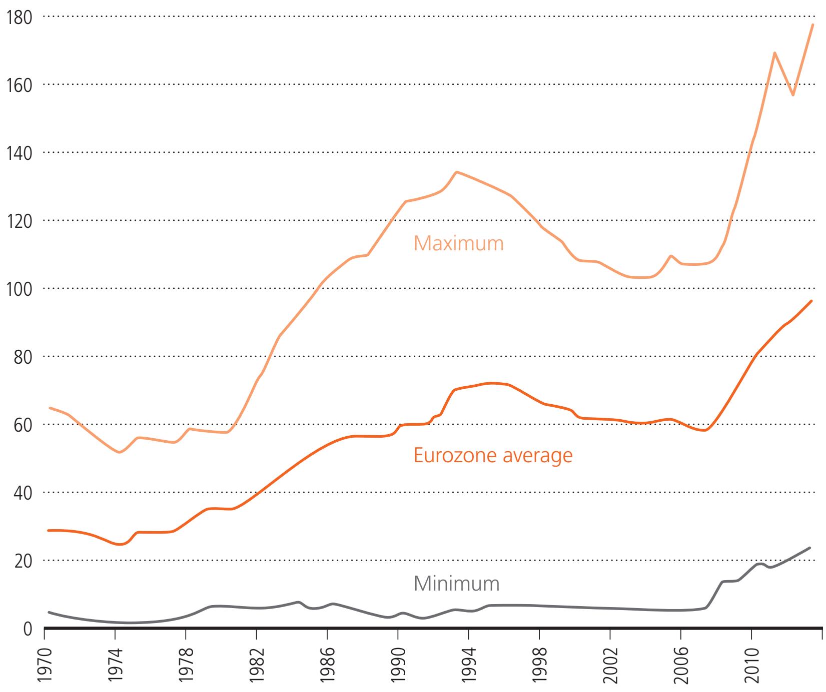
The typical northern euro-zone narrative of the crisis points to two specific weaknesses (or even ›sins‹) of the southern euro-zone countries that may explain their poor response to the crisis: **fiscal profligacy** (excessive public deficits and debts) and **loss of competitiveness** (large and persistent current account deficits) (for example, Sinn 2014). These ›macroeconomic imbalances‹, for which the southern euro-zone countries themselves were responsible, are also indicated as the causes that made ›austerity‹ *inevitable* (we shall return to this point in Section 4.1). Once again, these factors are present in the general scenario of the crisis, but they should not be overemphasised or taken out of context.

Concerning **fiscal profligacy,** it is hard to find evidence that it was a general cause of the crisis. Only in the case of Greece do we have a classic case of government profligacy (in the form of disguised public accounts). With the exception of the post 9-11 recession, from 2000 to 2008 there was a general stability of public deficits and debts, and, in the long-term view of **Figure 3,** one can spot a ›discipline effect‹ of euro-zone membership with a tendency towards downwards convergence of debt/GDP ratios before the 2008 crisis. More specifically, the average debt/GDP ratio of the southern euro-zone countries fell from 61.8per cent in 1999 to 59.6per cent in 2007, with Cyprus (51.5per cent) and Spain (35.5per cent) at the lowest end of the ranking of public debtors. As for budget deficits, with the exception of 2009, Italy has been running a primary surplus for more than 20years, although it was very small in 2001–2005. Spain had a primary surplus above 2per cent of GDP between 1999 and 2007. The true stability threats were nested, largely unnoticed, in **private debt/credit relationships** across the euro zone, the channel through which the financial turmoil migrated from the United States to Europe (for example, Lane, 2013; CEPR, 2015). The 2011–12 sovereign debt upsurge and turmoil was a *consequence* of the public sector's involvement in the private sector's financial crisis and the economic recession.

Shifting the focus from public to private finance implies a parallel shift from internal to **external imbalances.** The large current account deficits of almost all the euro-zone countries vis-à-vis the German surplus that opened up between 2004 and 2012 play a central role in the crisis narrative. So much so that yet another special purpose procedure was created by the euro zone amid the crisis, the Macroeconomic Imbalances Procedure (MIP), to be enacted by the Commission (EU Commission 2016). The rationale is that current account imbalances represent a threat to a monetary union because they create external debts that may become unsustainable.

The culprit was seen in the growing **divergences in competitiveness of the deficit countries**. The most common indicator is the real exchange rate, measured as the ratio of unit labour costs between one country and another (or an aggregate of trading partners). Indeed, setting the average real exchange rate of deficit and surplus countries equal to 100 in 1999, the former peaked at 117 in 2012 compared with 98 in the latter. The southern euro-zone countries were all in deficit, so that current account imbalances appeared to be another cleavage between the northern and the southern

Figure3
General government public debt as a percentage of GDP



Source: Wyplosz (2014)/

euro-zone countries. True, competitiveness, although hardly a notion that can be applied to a country (Krugman, 1996), is a critical factor for growth, and the northern euro-zone crisis narrative contains elements of truth. But criticisms have been raised and alternative views have been put forward that ought to be taken into account, on three main issues: (i) the relevance of current account imbalances in a monetary union, (ii) their causes and connection with the crisis, and (iii) their policy implications. Here is a brief overview of the main controversial points (see Mazzocchi and Tamborini, 2019, for extended coverage).

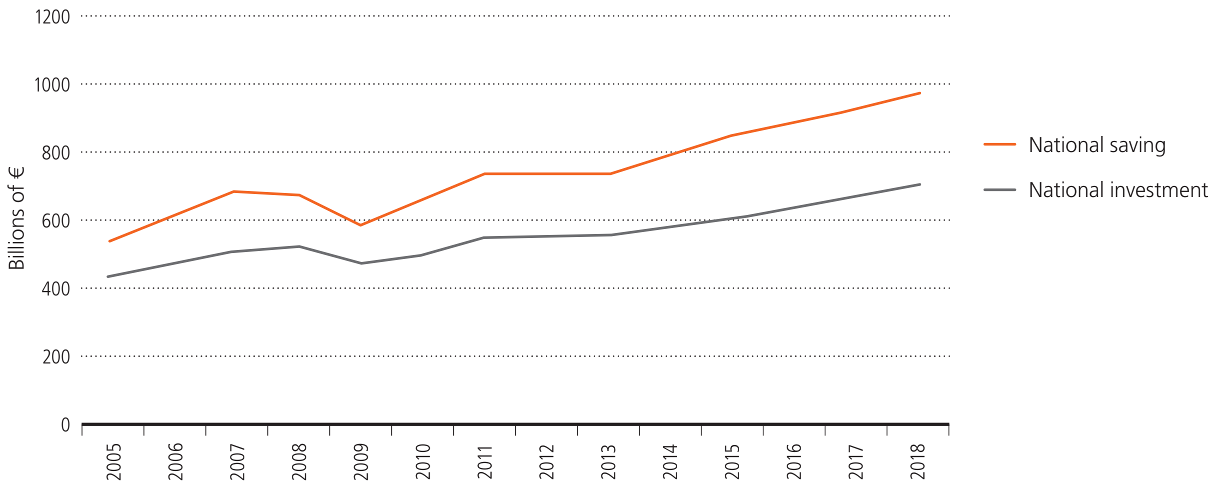
Looking first at long-standing federative countries, the question naturally arises of why internal current account imbalances are so important in the euro zone, whereas nobody worries about them elsewhere (ever heard about the current account imbalances of Florida or California?). One possible answer is that the **institutional setup** is a key factor in determining the nature, cause, consequences and policy options of internal current account imbalances (O'Rurke and Taylor 2013). Intra-euro-zone imbalances are not comparable with intra-US (or East–West Germany) imbalances because the euro zone is not a federal state, with a central government and a fully-integrated capital market. On the other hand, intra-euro-zone imbalances are not comparable with those that may occur among independent monetary sovereigns either, for the basic reason that the latter should be ready to cover payment imbalances with foreign currencies, whereas the euro-zone countries share the same currency (Pisani-Ferry and Merler 2012; Collignon 2014).

Second, most of the time, open economies, or regions within the same national boundaries, follow different growth paths, with different rates of growth of prices, wages, population, capital and employment. These differences quite naturally lead to large trade and capital flows. One classic argument in favour of free mobility of persons, goods and capital is precisely that it enables open economies to take different economic trajectories while having access to wider pools of resources. Large transfers of resources, mostly market-driven, are vital to the functioning of open economies (Blanchard and Giavazzi 2002). One cannot advocate financial liberalisation and integration, and then dream of a system of disconnected countries each with full sovereignty over ›their own‹ finances and standing on ›their own‹ feet.

Of course, it is also important to be aware that different economic trajectories, and the ensuing transfers of resources, may embed long-term troubles related to their sustainability. Identifying pathological imbalances is difficult, however, as testified by the ongoing debate on so-called ›global imbalances‹. To some scholars, competitiveness is a misleading approach to the problem and hence to the solutions (Wyplosz 2013, 2014.) The Macroeconomic Imbalances Procedure is certainly intended to come to terms with the complexity of this diagnosis, but having a detailed list of indicators is not, in itself, a failsafe way to make a good diagnosis, unless the interplay between the indicators is understood deeply and correctly.

Third, a case in point is the real exchange rate as indicator of competitiveness. The problem is that real exchange rates do not identify *the reasons* misalignments arise. The unit labour cost is the ratio between the wage rate and labour productivity; it may increase, relative to competitors, either because wages grow too much or because productivity grows too little. Esposito and Messori (2016) provide an accurate analysis of the determinants of real exchange rates in the euro zone that shows that while nominal wage growth and inflation were broadly aligned across countries, surplus countries enjoyed faster productivity gains that lowered their relative unit labour costs. This indicates that in the surplus countries wages were not keeping pace with productivity gains, or that **real wage depreciation** was under way. Is this kind of competitiveness policy sustainable in a monetary union? Is there a sense in which paying workers below their produc-

Figure 4
National savings and investment (Germany)



Source: authors' elaboration based on data from the AMECO database.

tivity should be a model – or a necessity – for the euro zone as a whole?

Fourth, a fundamental macroeconomic law states that a net exporter of goods and services that also registers **excess national saving** (private + public) above national (private + public) investment will also be a net exporter of capital (see **Figure 4** for Germany). Hence increasing credit-debt positions are an unavoidable consequence of the competitiveness race. Hans Werner Sinn evoked the colourful image that a party was going on in the South.[5] But the obvious question is, who brought the bottles. The idea, quite common among Northern populist leaders, is that the bottles were stolen from the wineries of the North. Yet this is nonsense. First, because in an integrated system capital flows freely where investors expect higher returns, and then because if anyone is to be a net exporter/creditor someone else has to be a net importer/debtor, and, according to another basic financial law, choosing the quality of their debtors is primarily a responsibility of the creditor.

3.3

The origin of the European crisis has to be sought in the **Europeanisation of the global financial meltdown.** Tracking current account imbalances in themselves is misleading; we really need to monitor the underlying financial relationships, the working of financial markets and the resulting weakness or resilience of the system. In parallel, the assessment should be extended to the institutional environment and the crisis management tools that are available. If cross-border loans are misallocated to faltering economic units, the problem is between lenders and borrowers, as in any ordinary risky transaction; if the borrowing units are ›too big to fail‹ the problem should be upgraded to the federal level. At the end of the day, what made the difference between the United States and the euro zone in the face of the financial crisis is that the fall of Lehman was tackled as a federal problem, not one of the State of New York only. Unfortunately, the sovereignty straitjacket is hindering progress also on this ground.

5 Speech in Wien reported by *Die Presse,* ›Euro ist in Explosion begriffen‹, 19 April 2012.

4

CRISIS (MIS-)MANAGEMENT

Different assessments of crisis management in the euro zone, and hence different positions regarding the necessity and direction of institutional reforms, are dependent on how one reads the causes of the crisis. As already mentioned, the northern euro-zone view of the crisis, focused on the southern euro-zone countries' fiscal indiscipline and loss of competitiveness, downplays the role of institutional flaws. In the previous section we showed that such a point of view is rather narrow and skewed. Also the **institutional dimension of the crisis** has to be brought to the forefront. The large array of criticisms levelled in this respect can be summarised under three main headings:

– the role of the fiscal regulation system,
– the lack of financial backstops,
– the (institutional) isolation of the European Central Bank

4.1

Concerning the **fiscal regulation system,** centre-stage has been so-called **›austerity‹,** namely the country fiscal consolidation plans enforced by the Commission in application of the Stability and Growth Pact (SGP). As is well known, this gave rise to controversy among scholars, politicians and public opinion. While in 2013 German Minister of Finance Wolfgang Schäuble declared that ›Nobody in Europe sees a contradiction between austerity and growth – We have a growth-friendly process of consolidation‹ (*The Wall Street Journal,* 11 April), as of today the consensus view is much less optimistic. The change of judgement was marked by the IMF's famous *mea culpa* about the large and persistent forecasting mistakes concerning the effects of austerity on growth (Blanchard and Leigh, 2013). All in all, one may say that there is now agreement that austerity has been **too early, too large** and **uncoordinated.**

As a reminder **Figure 5,** presents average annual austerity in the euro zone in comparison with the other EU countries and the United States. The euro zone is also split into the same sub-groups as in Figure 2: major NEZ4, small NEZ7, SEZ4 and Greece. It should be recalled that the SEZ4+Greece experienced severe financial distress and were subject to Excessive Deficit Procedures (EDP) or official support programmes (›Troika‹). Austerity is measured according to the official fiscal budget indicator adopted by the Commission for the EDP, that is, the structural budget in relation to potential gross domestic product (PGDP).[6] Austerity is identified by a positive change (more surplus or less deficit) of this indicator.

As to timing, almost all the countries in the dataset took an austerity stance in 2010, which peaked in 2012–13. The adoption of these fiscal adjustments was in part due to the generalised partial recovery of 2010 that followed the massive fiscal stimuli of 2009; it was, however, a short-lived spring followed by further slowdown in subsequent years. Nonetheless austerity was continued after 2012, though at a declining pace, which petered out in 2014–15. There are interesting differences within the groups. In the euro zone, the austerity turn was largely driven by the SEZ4 and Greece, averaging around 3.2per cent of PGDP in 2012. The northern euro-zone groups followed a smoother path. Therefore, ›large and front-loaded‹ austerity[7] within the euro zone has been concentrated in the southern euro-zone countries. The cumulated six-year fiscal consolidation amounted, in terms of PGDP, to 8.4per cent in the southern euro-zone countries (14.9per cent in Greece) compared with 1.7per cent in the northern euro zone, and 2.5per cent in the non-euro-zone EU countries.[8]

The notion of ›excess austerity‹ is basically related to the criticism that, despite the reform of 2003, the regulation system triggered austerity in a **pro-cyclical** manner, that is, during a slump (or more technically a ›negative output gap‹, when current GDP falls below PGDP). For instance, of the 196 budget observations in the database of **Figure 5,** 63.3per cent are restrictions. Of these, 15.8per cent are concomitant with negative growth, and 53.1per cent with a negative output gap.[9] More problematic is the case of the southern euro-zone countries, with a much higher occurrence of fiscal restrictions during actual recessions (42.9per cent) and negative output gaps (65.7per cent). These data suggest that

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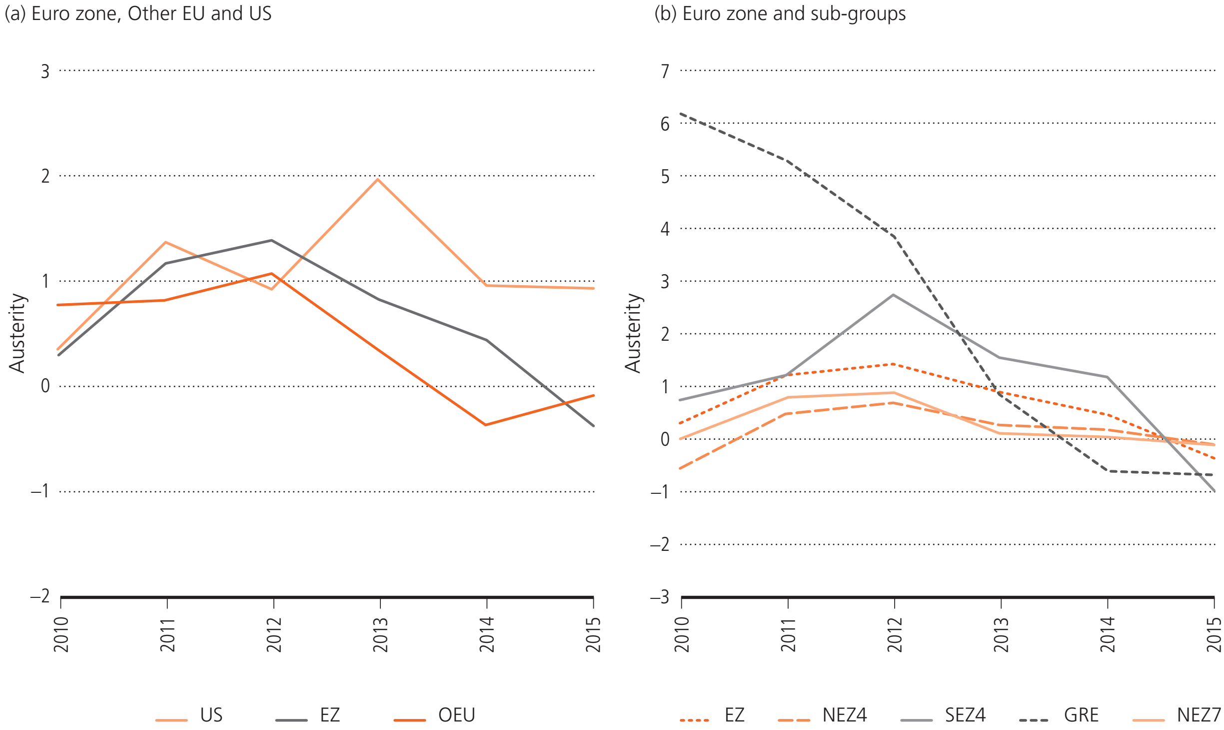
6 The structural budget is equal to the total budget *minus* the (estimated) cyclical component *minus* one-off measures.

7 ›Large and front-loaded‹ austerity was recommended by supporters of ›shock therapy‹ as a means to restore confidence and regain access to financial markets. See Buti and Carnot (2013) for a discussion and assessment.

8 Ireland, another country with a large banking crisis, cumulated 10.5 PGDP points of consolidation. France ended up midway between the northern and the southern euro-zone countries with 3 points.

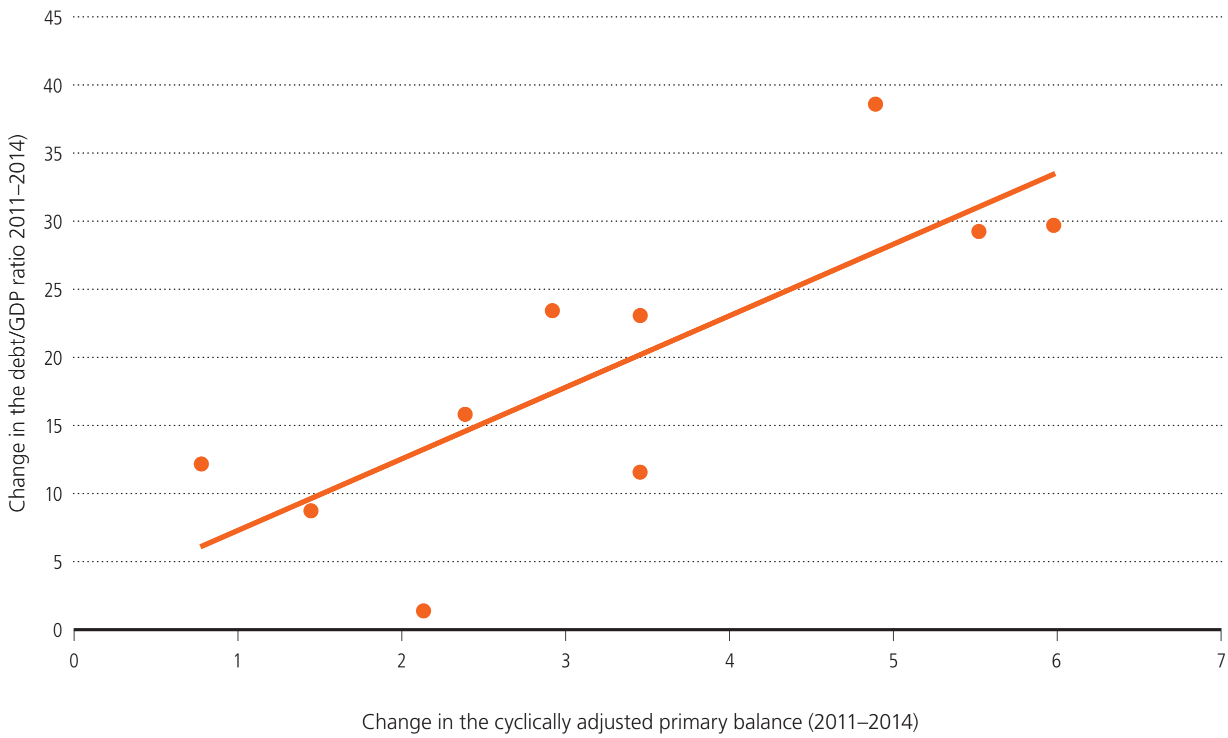
9 A negative output gap does not necessarily means recession: GDP may be below potential but still in positive territory.

Figure 5
Average annual adjustment in the structural balance as a percentage of potential GDP per group of countries 2010–15



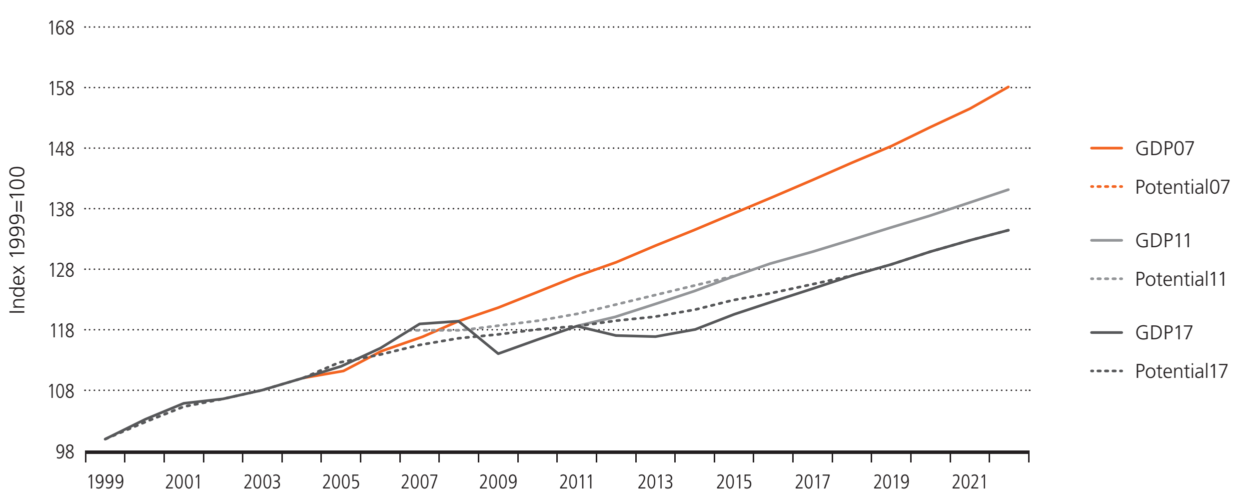
Source: authors' elaboration based on data from the AMECO database.

Figure 6
Debt/GDP ratio and austerity in the euro zone (without Greece)



Source: authors' elaboration based on data from the AMECO database.

Figure 7
Revisions to euro actual and potential GDP (from Fatás/Summers, 2018)



austerity occurred largely regardless of the cyclical position of the economy (despite the ›discount‹ of the negative cyclical position granted by the EDP).

There are two perverse consequences of pro-cyclical austerity. The first is that economic crisis may be aggravated to the extent that the fiscal restriction depresses aggregate demand more than it restores confidence. The second is that austerity may turn out to be **self-defeating for the purpose of fiscal consolidation**. In fact, the negative impulse to GDP growth may make the debt/GDP ratio rise instead of fall (Nuti, 2013; Tamborini, 2013; Boitani and Perdichizzi, 2019). While austerity quickly reined in fiscal deficits, **Figure 6** warns that the debt/GDP ratio grew more in those countries where stronger consolidation policies were enforced. Moreover it can be argued that untimely (that is, pro-cyclical) fiscal consolidation may have had long-lasting or permanent effects on potential output growth (Fatás and Summers, 2018), as shown by the recurring downward revisions of euro-zone potential output (**Figure 7**).

We have seen that austerity was implemented most severely in the countries suffering from public finance distress, which clearly stand out as the epicentre of austerity. On one hand, this may appear justified by the fiscal emergency; on the other hand, one may wonder why almost all other countries were also pushed into austerity to a non-negligible extent. Thus, the euro-zone experience can be qualified as one of **›uncoordinated austerity‹,** which may have created unfavourable conditions for the countries facing stronger pressure for fiscal consolidation.

In fact, the country-by-country system of fiscal regulation is another problematic aspect in a large area of highly integrated economies that easily transmit shocks one to one another (see, for example, Tamborini, 2013; Baglioni et al., 2016). Empirical studies published by the European Commission (int' Veld, 2013; Berti et al., 2013), provide measures of these reciprocal ›spillover effects‹ of fiscal consolidation plans; ignoring them may explain part of the serious underestimation of the growth impact of plans on each country and the euro zone as a whole.

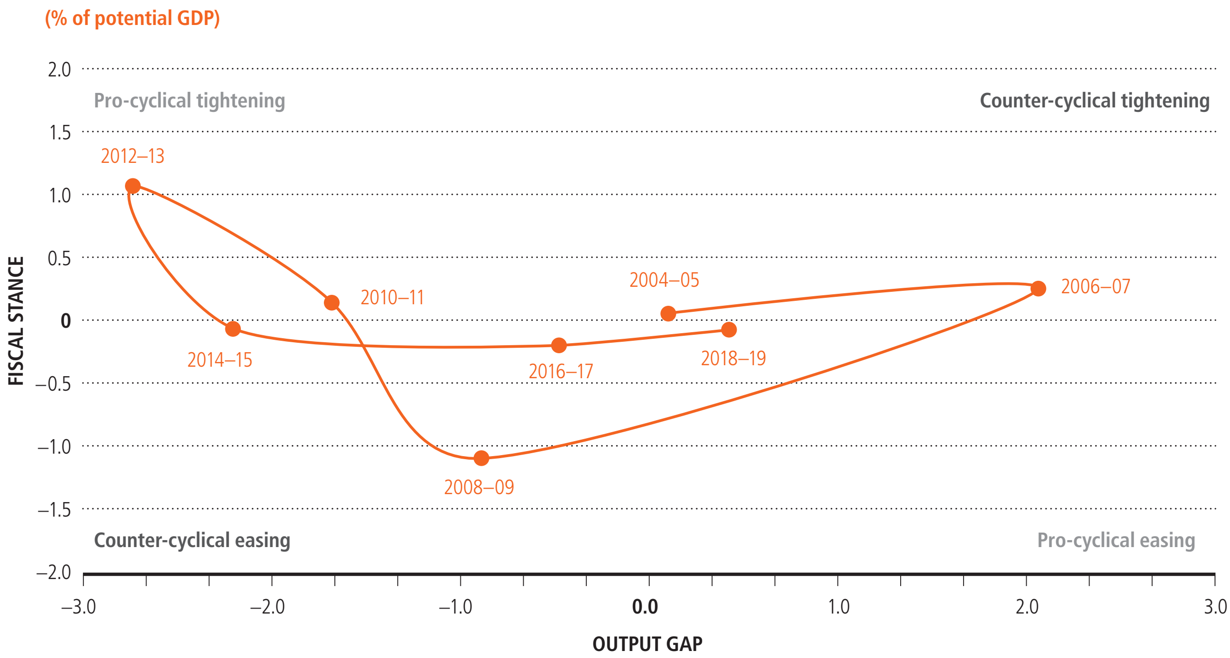
4.2

The absence of a financial backstop is another critical factor revealed by the crisis once it is recognised that it originated in a chain of private market-and-regulation failures triggering the involvement of the public sector. True, the sharp differences in market reactions, reflected in the sudden jump in the interest rate spreads of some countries (Greece, Spain, Ireland, Italy, Portugal) relative to Germany, was partly due to specific weaknesses, notably the pre-existing high debt. But apart from Greece, this was the case of Italy, not of Spain, Portugal or Ireland.

Extensive empirical research has detected other factors that are unrelated to the so-called ›fundamental valuation‹ of sovereign debts (for example, Caceres et al., 2010; Favero and Missale, 2011). Particular attention has been devoted to clear symptoms of **›self-fulfilling‹ speculative attacks,** that is, contagious beliefs about the insolvency of a sovereign that become true as they trigger fire-sales of its debt, and a **›euro dummy‹ effect,** or an extra premium charged by investors with regard to non-euro stand-alone countries with similar debts, due to the lack of a lender of last resort in the euro zone (see, for example, De Grauwe and Ji, 2012, 2013). The immediate impact of the ECB's ›whatever it takes‹ stance on interest rate spreads in 2012 showed quite clearly that the **redenomination risk** (the risk that one or more countries might exit the euro) was a major factor in the euro-area crisis (Bini Smaghi, 2018), as such a risk adds to the premium charged by investors on distressed countries' sovereign debt.

These phenomena also cast a shadow on the doctrine of ›market discipline‹, which complements the principle of exclusive national responsibility and the no-bailout clause among governments, because markets turn out to be undis-

Figure 8
Aggregate fiscal stance of the euro zone in relation to the business cycle



Source: Hartmann and Schepens (2019, p.13).

ciplined and in need of stricter discipline themselves. While calling for better ex-ante regulation of capital markets, this view also calls for the introduction of proper financial backstops in order to stabilise markets when they do not take of themselves (CEPR, 2008).

4.3

The (institutional) **isolation of the European Central Bank** (ECB) is the third major bug in the system. This is a foundational principle, but, as often happens, it also has a dark side that should be considered, namely that monetary policy cannot bear on its shoulders the entire weight of a major crisis. This awareness has had to be painfully won through crises all over the world (for example, Blanchard et al., 2010; Draghi, 2014a, 2014b; Boone and Buti, 2019); dismissing it as an attack on the independence of the ECB reflects autarkic thinking and is a serious mistake.[10]

There is therefore a broader sense in which euro-zone fiscal regulation lacks coordination, namely **between the monetary and the aggregate fiscal stance of the euro zone** (Draghi 2014a, 2014b; Boone and Buti, 2019). Indeed, the principle of central bank independence safeguards the efficacy of monetary policy, shielding the central bank against a contrarian fiscal stance on the part of the government (so-called ›monetary dominance‹). Usually, efficacy is thought of in terms of price stability *upwards,* so that when a tight monetary stance is needed, the fiscal stance should not be expansive. But the same holds in terms of price stability *downwards,* so that when monetary easing is needed, the fiscal stance should not be restrictive.

The pro-cyclicality of the euro zone's aggregate fiscal stance and its being out of sync with monetary policy has been well documented. By way of example, **Figure 8** (Hartmann and Schepens, 2019) plots the euro zone's aggregate fiscal stance (the official primary balance net of cyclical factors) in relation to the business cycle (the official output gap). The pro-cyclical combinations include fiscal restriction and negative output gap (north-west quadrant), and fiscal expansion and positive output gap (south-east quadrant). The post-crisis years 2010–15 were characterised by pro-cyclical tightening, in line with our previous assessment.

10 As is well known, the northern euro-zone countries expressed widespread hostility to the ECB's policy choices after the crisis, in particular the prolonged regime of zero or negative interest rates, which was accused of ›expropriat[ing] savers‹ (Bindseil et. al, 2015). According to mainstream macroeconomics, policy rates are low because the returns on productive capital are low, not vice versa. If inflation is near zero and the returns on capital are low the central bank is bound to set near-zero policy rates to countervail deflationary and recessionary pressures (Yellen, 2014). Hence, the right question for a serious public debate is why the return to capital is so low (a question that is engaging leading macroeconomists worldwide). A possible explanation – the so-called ›savings glut‹ hypothesis put forward by Ben Bernanke (2005) – looks at the permanent and increasing excess, around 4–5 per cent of GDP, of savings over investment (both private and public) in Germany and in the euro zone as a whole (see again Figure 6). One may then ask whether a more expansionary fiscal (public investment) policy would not be preferable, alongside higher real interest rates, now and in some likely future recession (Blanchard and Summers, 2019), instead of sticking at *Schwarz Null* and asking for higher policy rates by fiat of the central bank.

5

THE EURO ZONE WOULD BE FINE AS IT IS, IF ONLY THE SOUTHERN EURO-ZONE COUNTRIES…

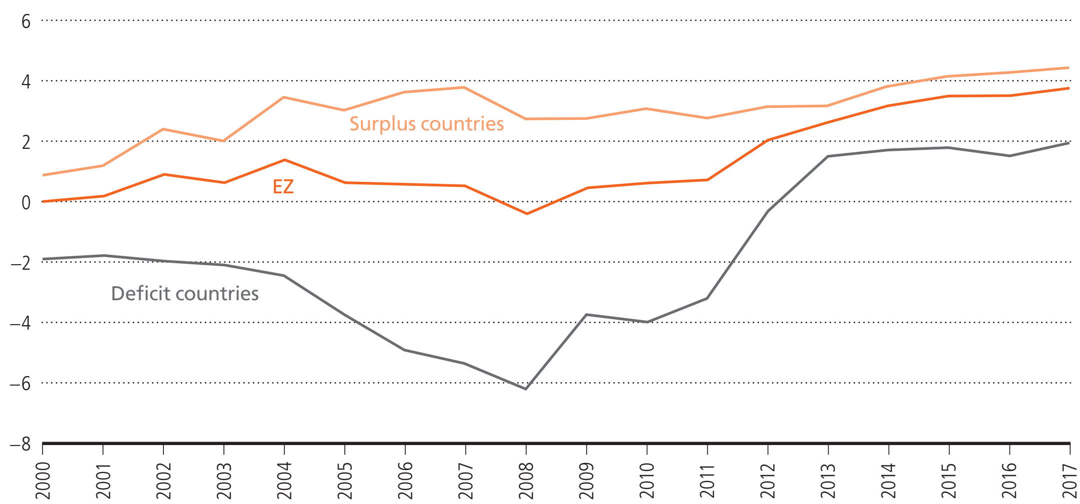
Does the euro zone perform poorly because of the southern euro-zone countries? Is the apparently deep cleavage in the euro zone due solely to the fact that southern euro-zone countries are not able (or are reluctant) to abide by the common fiscal rules or make structural reforms and become more competitive? Or is there something in the export-led model based on competitiveness, a balanced budget and restrained internal demand that is incompatible with being *magna pars* of an economic and monetary union? A few reasons explain why the dragging anchor of the euro zone is not primarily the southern euro-zone countries, and why retrenchment to a Northern euro may remain a Panglossian dream.

5.1

With the Single Market in an institutional vacuum, a ›competition union‹ has been established in the EU, in the sense of an arena in which countries are called on to participate in a championship, with losers and winners in terms of trade and GDP shares. The idea or assumption is that losers will learn from winners so that all will be winners in the end (as if that were possible). Of course, winners may be happy with this ›hunger games‹ (Storm and Naastepad, 2013), and losers do indeed have to try to understand why they have been losing and how to improve. But the ›competition union‹ entails (if it does not create) losers to absorb the excess capacity of the winners; hence losers (net importers) are not so much a burden on the winners (net exporters) as necessary for their success. When talking about the costs and benefits of the monetary union, serious and responsible opinion makers in the winner countries need to explain that having losers tied up in a common currency is a key factor in their success (the alternative would be a systematic appreciation of the exchange rate which would annul their competitive advantage, as happened in the 1970s and 1980s).

Fervently pro-euro advocates should also look at the overall performance of the euro zone and warn that a ›competition union‹ is bound to end up in ›a zero sum game‹. If net importers struggle (or are forced) to become net exporters themselves (as happened during the crisis), outlet markets shrink for all. The winners take home the largest share of a shrinking pie, as the euro zone's declining overall macro-performance indicates. There is only one escape from this zero-sum game, namely, that all countries become net exporters vis-à-vis the rest of the world. This is in fact what has

Figure 9
Current accounts as a percentage of GDP in the euro zone, the deficit countries and the surplus countries



Source: authors' elaboration based on data from the AMECO database.

been going on in the past three or four years (only France now has a foreign deficit), as clearly shown by **Figure 9.**

Does this mean that the ›competition union‹ may turn out to be a success? Not really. The implication is that the euro zone as a whole is developing production capacity well in excess of domestic demand. The data also show that extra-euro zone trade has substituted, not integrated, intra-euro zone trade (Mazzocchi and Tamborini, 2019). That is to say, we have created a single market of about 500million people, but our industries depend on the ups and downs of foreign demand and political benevolence. And both will be ›down‹ for the foreseeable future. Does more production for the domestic market mean that, say, Germany is likely to become less competitive? Certainly not. To provide a simple example, if BMW sells fewer cars in China and more in Germany, this does not mean that BMW is less competitive – let alone Germany – for the simple reason that BMW's competitors are basically the same all over Europe (in fact, all over the world).

The export-led growth model long pursued by Germany is appropriate to small, open economies and to emerging economies (or even countries in the aftermath of a devastating war). For large developed economies, however, this may become unsustainable when they already command a disproportionate share of world trade. They become subject to the risks of sudden obstacles to their exports because of trade barriers set up by other countries. This argument also calls into question the objective of transforming the euro zone, even the EU, into an export-led (highly competitive) economic area. The abovementioned risks would be magnified: trade wars might be triggered with the rest of the world even more easily than in the case of a single (albeit large) export-led country, such as Germany.

6

WE NEED MORE EUROPE. BUT WHICH ONE?

As already mentioned, the ›consensus view‹ about the euro zone reached by international scholars after the financial and economic crisis also includes a number of critical flaws in its institutional design. The production of high-level scholarly reform proposals has been relentless (most recently, a document produced by 14 French and German economists, which had a substantial impact in the media: CEPR, 2018). Some of them have been endorsed or put forward by the Commission and other euro-zone authorities, although the response from northern euro-zone governments has sometimes been cool, if not openly hostile.[11] Thus behind the general agreement (among scholars and pro-European political parties) that ›we need more Europe‹, and that something should be done, disagreement between northern and southern euro-zone countries looms large on a number of key issues. The apparatus of fiscal governance is pivotal in this debate, and whether and how to reform it is at the forefront of the political divide (see, for example, Delatte et al., 2017; and Asatryan et al., 2018, for an overview). The state of play can be epitomised in two alternative reform models.

6.1 THE MAASTRICHT 2.0 MODEL

Through a northern euro-zone lens, the European crisis originated in the **political** failure of the fiscal regulation system that governments signed up to with the Maastricht Treaty and subsequent modifications up to the Fiscal Compact of 2012. It was not the compliance with, but the violation of these rules (with the benign neglect of a ›politicised‹ Commission) that generated the crisis, whereas these rules remain a fundamental pillar of a sound euro zone. The typical symptoms are the persistence of a deficit bias in fiscal policy, public debt growth and transmission of public finance distress. There are two keystones to this view.

The first is the reaffirmation of the doctrine of **exclusive national responsibility** in all economic matters, except monetary policy, on which the Treaties rest. On the other hand, fiscal sovereignty is limited by a set of rules that are necessary to ensure fiscal discipline and ›monetary dominance‹ (that is, full independence of the European Central Bank vis-à-vis governments), which means no bailouts of insolvent governments and no monetisation of public debt, based on the understanding that a monetary union, in the absence of rules, creates incentives to violate fiscal discipline, leading to ›fiscal dominance‹.

The second keystone of the Maastricht 2.0 roadmap is the proposal that the Fiscal Compact, after being embodied in the legislations of member states, be elevated from the status of an international treaty to the rank of EU legislation. Consequently, when the advocates of this view talk about ›more Europe‹ they mean further devolution of sovereignty towards supranational agencies that are essentially ›technocratic‹ in nature (for example, the European Fiscal Board and national fiscal boards) with a clear mandate and power to enforce the rules vis-à-vis governments.

6.2 THE CONFEDERAL MODEL

Various strands of critical thinking on the euro-zone architecture converge on this alternative model, as well as the main southern euro-zone governments, with France as possible mediator (as can be understood from Macron's famous Sorbonne speech in November 2017).

In this view, the crisis brought to the fore two problems in particular. The first is that **no one is in charge of the euro zone** as a whole at the supranational level, with the exception, by statute, of the ECB. The second is that existing governance mechanisms have proved **unable to coordinate national policies** and provide proper **macroeconomic stabilisation,** as we summarised in Section 4.

There are also deeper concerns regarding the political and institutional side. The euro zone as a supranational institution is not only incomplete, but has also failed to promote democratic governments' legitimate role as representatives of social preferences concerning policies and their outcomes (Andreozzi and Tamborini, 2019). A sharp conflict has emerged between the ›Community method‹ (law- and decision-making are reserved to Community bodies) and the ›intergovernmental method‹ (which some label the ›law of the strongest‹: see Bastasin, 2015; Fabbrini, 2015). There have already been experiments with tightening the existing regulatory system, with poor results as regards crisis management and further deterioration of the ›input‹ and ›output‹

11 We may also recall the opposition document signed by the finance ministers of the ›Hanseatic League‹.

legitimacy of the euro-zone policymaking process (Scharpf, 2015; Schmidt, 2015).

Reforms should therefore point in the opposite direction from Maastricht 2.0. The confederal inspiration should be understood in a broad sense; in other words, the aim should be to create areas of genuinely supranational government (not just governance) with clear institutional legitimacy in relation to both the EU order and the national constitutional orders.

7

STALEMATE

It is natural to wonder how is it that, so far, none of the many proposals for euro-zone reform have received political support. The answer is simple. There is general dissatisfaction with the status quo, but diagnoses and cures, not to mention national interests, differ at the political level, and so reform agendas differ as well. Therefore, in the foreseeable future Europe will see not only a battle between pro-European and anti-European forces, but also confrontation between different views on its own future. This confrontation will be more courteous, but no less tough and probably more far-reaching. This is because bad reform, or no reform, will also, sooner rather than later, pave the way for the final victory of the mounting anti-European forces.

At the root of the stalemate is North–South mistrust (Okansen, 2019). Adopting theoretical lenses, the stalemate has the typical features of a ›prisoner's dilemma‹, a prototypical non-cooperative game in which each player (governments on behalf of their voters) prefers the costs of non-cooperation than the higher costs of being the only one who cooperates (Andreozzi and Tamborini, 2019). The paradox is that both players suffer costs instead of reaping the benefits of cooperation. One instructive feature of the game is that both players act rationally in their own interest, hence the attempts at blame shifting that we see among governments (and in the popular media) are mere rhetorical expedients. This perverse game is certainly exacerbated by the increasing success of sovereignist, populist and anti-European parties and movements in shaping the agenda of ›mainstream‹ parties still in power.

The political lines of defence against undesirable changes in euro-zone governance are often buttressed by reference to economic principles on both sides. Here we wish to discuss briefly, and non-technically, two keystones in northern euro-zone positioning: **rules against discretion** and **risk reduction versus risk sharing.**

7.1

Rules are the backbone of the euro zone as they are enshrined in the Stability and Growth Pact and subsequent modifications, up to the Fiscal Compact. ›Elections change nothing, there are rules‹, Wolfgang Schäuble is reported to have said.[12] Can a monetary union survive without fiscal rules? Obviously no. But this is no reason to have bad rules.

Behind technical disputes, the whole matter under discussion is about **contracts among governments** (high-rank contracts at quasi-constitutional level). These involve mutual trust and credibility. According to some scholars the extension of rules is inversely proportional to mutual trust, of common European citizenship, of a common money without a common state. The strong and tight regulatory apparatus demanded by the northern euro-zone countries would thus be a measure of their distrust of their southern euro-zone counterparts. But how far can rules go? The limit eventually lies in the fundamental issues of **uncertainty** and **contractual incompleteness.**

Because the ideal conditions of complete contracting (a complete specification of ›if… then‹ clauses on all possible states of the world) seldom occur in reality, the clear-cut solutions to be found in the ›rules, not discretion‹ prescription can hardly be applied. If anything, in the real, changing world, rules may become obsolete, as they reflect the political-economic state of the art at the time they are drafted. Let us quote a thinker regarded as the pole star of (neo)liberalism:

> ›If man is not to do more harm than good in his efforts to improve the social order, he will have to learn that in this, as in all other fields where essential complexity of an organised kind prevails, he cannot acquire the full knowledge which would make mastery of the events possible‹ (Hayek, 1974, p.7).

Indeed, what we observe in reality (except in the euro zone?) is that the higher the legal rank of a contract (for example, constitutions), the more the contract contains general and abstract principles (or the less it contains specific and state-contingent mandatory rules). ›Discretion‹ is a necessary evil, as it were, of incomplete contracts, and the true task of high-ranking agreements is **how to discipline, not suppress, discretion.** This is generally accomplished in two dimensions. First, define who is legitimised to exert discretionary decision-making – in liberal democracies these are

12 ›Greece the dangerous game‹, BBC News, 1 February 2015, https://www.bbc.com/news/world-europe-31082656

elected representatives. Second, strike a balance between tying the hands of the decision-maker (to minimise the abuse of authority) and its scope of effective discretion in the face of unforeseen contingencies (remembering that the voters expect those they elect to exert their powers in such contingencies).

Mario Draghi, in his speech at the award of the *Laurea honoris causa* in law from the University of Bologna (Draghi, 2019) pointed out two similar reasons why pure rule-based policymaking has proved to be unsuited to the euro zone. The first is that rules are static; in other words, they ›cannot be updated quickly when unforeseen circumstances arise, while institutions can be dynamic and employ flexibility in their approach‹ when economic conditions abruptly change. Rules lose credibility if applied with discretion and/or with some sort of opaque ›flexibility‹. ›This is why there are always tensions when it comes to economic policies that follow the rules-based approach.‹ The alternative is an **institution-based approach,** that is institutions invested with a mandate and defined powers, which can be subjected to democratic control.

At the root of the problems that cripple the euro zone and its further progress, we think, lies an obdurate illusion that these fundamental questions of viable, credible, long-lasting legal agreements may be circumvented. We would be doing the euro zone a good service if we were able to bring this challenge to the fore.

More fundamentally, we wish to stress something else that has contributed to creating a cleavage between North and South – Italy in particular – concerning ›the rules‹. The – not unreasonable – perception that the fiscal rules are the only ones that really matter. Many people ask themselves: **is there in Europe anything as important as respect for the fiscal rules?** Think also of fiscal dumping, tax heavens, social dumping, excess trade surpluses and, beyond the economy and money, migrant distribution shares, free-riding in foreign policy or even respect for the values of liberal democracy. Some countries that may have difficulty respecting the fiscal rules, but who feel and are respectful of other European commitments and values, have a sense that there is ›selective severity‹, which does not help to make them more amenable to fiscal rules.

7.2

Another effect of mistrust which has been given a high academic profile is the threat of **›moral hazard‹,** which is ubiquitous in northern euro-zone rejections of reform proposals involving some degree of mutual insurance. This argument is also the main firewall against the creation of a common budget. In simple words, the northern euro-zone countries reject mechanisms that may relieve the pressure on weaker (southern euro-zone) members to reform themselves and behave properly, as well as leading to permanent transfers to southern euro-zone countries. Important as it may be for an accurate design, moral hazard seems overstretched and to some extent a cover for political fears. Discussing the subtleties of moral hazard is beyond the limits of this paper, but a couple of general considerations are in order.

If moral hazard were fatal to insurance schemes, insurance companies would have not survived. The theory and practice of controlling moral hazard have made enormous progress in parallel with risk management techniques. For instance, the argument that shock absorbers (for example, unemployment benefits) may conceal permanent transfers assumes an inability to distinguish between a shock and a permanent state. True, this is a difficult distinction to make, but it has not prevented the adoption of the Fiscal Compact based on that distinction. The abundance of available proposals for shock absorbers have been elaborated by leading scholars and include devices that minimise moral hazard (see Section 8 below). On the other hand, the fact that moral hazard has two sides is almost ignored. Besides the – most feared – choice of buying insurance and taking on too much risk for all, there is the failure to buy insurance as a consequence of under-rating of risk (›it can't happen to me‹). In the former case there is over-insurance, in the latter under-insurance. Both are collective failures that impose welfare losses on all.

7.3

A related example is the northern euro-zone countries' sine-qua-non two-stage strategy of **risk-reduction prior to risk-sharing,** that has slowed the progress of the Banking Union. Although it seems reasonable, the two-stage strategy is based on uncertain foundations. According to classic risk theory, the distinction between risk reduction and risk sharing is superfluous: risk sharing *is* a means of reducing risk. In this view, risk is something intrinsic in an asset (such as mass in physics); it cannot be reduced in absolute magnitude, but it can be distributed efficiently among asset-holders according to their own degree of risk aversion.[13]

A second weakness of the two-stage strategy arises if it is recognised that financial risks are to some extent endogenous. Suppose now that there are many banks with non-performing loans that seek to sell them all together. The effect is that the interbank market shrinks, prices plummet, volatility increases and the market value of banks' assets falls. These effects make the whole system more risky. This also applies to banks forced to sell sovereign bonds. Along with the two-stage strategy there would be a higher probability of a new financial crisis, while the redenomination risk, far from decreasing, would skyrocket once again, as it happened in 2011–2012 before the ECB announced it would do ›whatever it takes‹ to save the euro.

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13 Consider a bank with large non-performing loans. These can be sold at a discount to a specialised intermediary happy with a higher risk-return profile. Both the bank and the intermediary are better off, but the system as a whole is not safer. Technically speaking, the euro zone may be safer if the intermediary is non-resident, but this is something of a hypocritical notion of risk reduction (if the non-resident intermediary goes bust it may have contagious effects on resident intermediaries connected with it). Risk reduction can, at most, be an *ex-ante* policy strategy based on micro- and macro-prudential tools.

Here, as in other areas, there seems to be an obdurate resistance to recognising the systemic effects of seemingly efficient (or convenient) policies taken in isolation. Past president of the ECB Mario Draghi has stressed (as also documented by the Franco-German economists in CEPR, 2018),

> ›the dichotomy between risk-reduction and risk-sharing that characterises the debate today is, in many ways, artificial. With the right policy framework, these two goals are mutually reinforcing. Public risk-sharing through backstops helps reduce risks across the system by containing market panics when a crisis hits. And a strong resolution framework ensures that, when bank failures do happen, very little public risk-sharing is actually needed as the costs are fully borne by the private sector.‹ (Draghi, 2018)

8

LOOKING FORWARD, THINKING EUROPEAN

One year after publishing their proposals, the French-German economists have written:

> ›To summarise, the problems that prompted our January2018 paper are still there, new problems are on the horizon, and the current state of the policy conversation on euro area reform is disappointing. Leaders and ministers seem to lack the sense of urgency and the sense of purpose that would be needed in the current situation. They do not seem to appreciate the lingering fragility of the euro area, the proximity of the economic risks, and the danger of relying excessively on the ECB for addressing problems that political leaders are unwilling to solve.‹ (CEPR, 2019, p.3)

We argued above that the root of the stalemate of the reform process is North–South mistrust, coupled with the capture of the political agenda by sovereignist, populist and anti-European forces, even where they are not in government. In order to break this state of non-cooperative deadlock, first of all it has to be made crystal-clear that, whatever new governance is adopted, it must be the result of **›bilateral disarmament‹,** if not a shared view, between the northern and the southern euro-zone countries. That is, no one-to-one correspondence can be achieved between rules and national interests, nor is such a one-to-one correspondence desirable in the euro zone (supranational) perspective.

We conclude our reflection with a brief overview of the proposals that we deem most urgent and potentially effective, divided into two main areas: **structural policies,** aimed at addressing the long-term goals of development and cohesion, and **macroeconomic policies,** aimed at providing adequate capacity of control and stabilisation of business cycles in the short to medium term, while guaranteeing public finance stability. Our focus will be not so much on specific policies, but on renewing the **euro zone's institutional setup.**

8.1

›United in diversity‹, it is too often forgotten, is the motto of the EU. The northern euro-zone countries seem stuck on the German original position that monetary unification should follow, not precede deeper economic, social and political convergence and integration of member countries. All the euro zone's troubles are traced back to the ›original sin‹ of introducing the euro ahead of economic and political integration. As a result, the normative benchmark for the euro zone is zero divergences across countries.

The euro-zone institutions and most policy advisors put great emphasis on convergence through structural reforms – whatever they mean – in order to both improve welfare in each member state and prevent cohesion tensions. This recommendation is notoriously controversial, to say the least. One controversy concerns the nature of any structural reforms. In fact, ›structural reforms‹ *par excellence* are those of the neoliberal package also known as the Washington Consensus or, in Europe, the Brussels-Frankfurt-Berlin Consensus (for example, Campos et al., 2018; Haas et al., 2019). A more radical point is that the goal of no disparities may not necessarily be right, feasible or flawless. General research on growth, and inter-regional studies within federations and single nations, teach us a lot.

First, there seems to be a persistent confusion between the need for each member state to actively discover its own way of thriving in the European Union, and the goal of convergence to homogeneous economic structures. The former endeavour requires a long-term capacity for evolutionary adaptation, **provided that the environment (the common institutions and other countries' behaviour) is favourable.** The latter is neither strictly necessary on a normative basis nor is it observed historically. Regional differences are physiological, both at the level of socio-economic structures and at the level of macro-performances (per capita income and growth, productivity, employment). Most recent studies on the euro zone find mixed evidence, though no dramatic departures from these patterns, and some tendency to convergence, if anything (for example, Imbs and Pauwels, 2019; Kalemli-Özkan, 2019). However, the map of differences changes a lot if we consider the euro zone at the level of regional entities. True cleavages do not respect state borders, as we have already suggested (Section 2; see Demertzis et al., 2019).

A second issue is the correct identification of **what really matters as regards diversity,** what are the causes and the consequences. As to causes, more recent research has focused on **›institutional quality‹,** in itself a complex (elusive?) concept that encompasses a number of deep characteristics of a particular society. From this point view, euro-zone diversity may be wider (and deeper) than in the United

States or in other long-standing federations (Casagrande and Dallago, 2019). The reason is that, in this area, history, culture and nation-state-building matter most and weigh heavily on the euro zone. As to consequences, however, not all dimensions of diversity put a union under stress with the same intensity. Is divergence in per capita incomes or employment rates the real threat, or is it fiscal indiscipline, or financial instability? There is no once-and-for-all answer, but it is necessary to come up with one, in order to make the euro zone safer.

In the third place, as shown by the literature on institutional benchmarking, **differences across dimensions of institutional quality are not univocal.** The up-to-date assessment provided by Casagrande and Dallago (2019) defines a multidimensional EU benchmark of institutional quality based on the EU founding treaties and laws, and shows that no one member state excels in all dimensions. Each has its own strengths and weaknesses. What should the evergreen plea for ›structural reforms‹ aim at?

Finally, local performances are always the result of local factors and external factors, so-called ›spillover effects‹. These can be positive or negative. The larger the spillover the more collective gains can be obtained by creating higher level institutions, which for the euro zone would mean moving towards a full-fledged federation (Baglioni et al., 2016). This is clearly utopian for the time being and so the public should be informed that we are bound to live in a Union in which it is most likely that each country, and the Union as a whole, will underperform.

Therefore, a more promising approach should start from the questions: how far should convergence go in order to have a viable Union? Convergence on what? What can, and should, the Union do to create a favourable environment for all countries to thrive? These questions remain largely unanswered. From this point of view, the euro zone appears particularly ill suited to withstand internal disparities. Again, comparison with existing federal systems is instructive. There, institutions are designed in view **both of reduction and co-existence of disparities.**

Alas, a multi-level division of competences is not possible in the euro zone, in which each government is fully responsible for its own policies, and fiscal transfers are banned. The picture is further complicated by the fact, mentioned above, that the geography of disparities does not respect national borders. Hence, the policy message that each national government should take care of its own structural problems is over-simplistic and it may create further tensions and disparities. On the other hand, the attempt at transforming the baddies (southern euro-zone countries) into goodies (northern euro-zone countries) through external agencies would be rejected by southern euro-zone voters, on both the right and the left, not to mention the populists. Indeed, it would be a violation of fundamental principles if a sovereign government were forced to follow a specific policy strategy based on a particular view of the economy and society.

8.2 RETHINKING FISCAL RULES AND MACRO-POLICIES IS THE PRIORITY

The resistance towards strengthening the euro zone's macroeconomic stabilisation capacity is puzzling. On the academic side, there is general consensus that it has proved largely inadequate in the face of the past crisis (see Section 4), and so it will be on the advent of the next one (CEPR, 2019). The idea that (market-oriented, export-oriented or ›supply-side‹) structural reforms can dispense with macroeconomic stabilisation, which seems entrenched in the northern euro-zone mind-set and was largely propagated by the euro zone during the crisis, has proved seriously flawed (for example, Campos et al., 2018). On the other hand, if creating new common stabilisation tools is not easy, it appears less demanding, from the institutional and political points of view, than more ambitious steps towards further integration. Further inertia on this ground hardly seems justifiable.

Let us review two main critical issues: **national fiscal rules** and **common stabilisation policies**. These two dimensions can no longer remain detached (Seikel, Truger, 2019). Although a ›great reform‹ is not to be adopted all at once, the overall perspective and each step should be made clear in advance. The good news is that one of the main euro-zone institutions, the **European Fiscal Board,** has now taken the lead in this line of reform (EFB, 2019), providing a balanced framework for further discussion. Moreover, some indications can also be found in the Mission Letter to the Commissioner-designate for the Economy by the new **President of the European Commission**.

The new fiscal regulation system does not necessitate a major overhaul of the Treaties. It is likely to remain faithful to the Maastricht Treaty commitment of the member states to maintain sound public finances. It should be made clear that reforms of the rules are not intended as an easy way to dispense with responsibility in debt reduction on the part of highly indebted countries. **Debt reduction must take place** where and when necessary. In particular, member states should comply with the principle that national governments are free to broaden or restrict welfare state provisions in their own countries while complying with the government budget constraint, guaranteeing that fiscal revenues are tuned to match public spending, at least in a reasonable time span. **No new structural current expenditure should be permanently debt financed**. This principle has been overlooked at times or permanently in some southern euro-zone countries (Italy and Greece are the leading examples).

The first pillar of the reform, as in almost all proposals in circulation, as well as in the Mission Letter to the new Commissioner-designate for the Economy, is that the new system should reconcile **long-term sustainability of public debt** with **stronger stabilisation tools and policies,** and the accumulation of public capital:[14]

14 ›You will ensure the application of the Stability and Growth Pact, using the full flexibility allowed in the rules. This will help us achieve a more growth-friendly fiscal stance in the euro area and stimulate

– Debt reduction plans must therefore be **credible** as to timing and intensity, which means that governments should take consistent actions, which should also be politically viable and economically sound (plans calling for ›blood, sweat and tears‹ are likely to be punished by investors).
– In the spirit of controlled and disciplined discretion, as mentioned above (see Section 7), the debt target may remain 60per cent of GDP – although ›the norm is, indeed, to a large extent arbitrary‹[15] – but ›the adjustment of public debt could be made country-specific, either by changing the reference values of the Treaty protocol, or by differentiating the speed of adjustment towards the current debt reference value‹ (EFB, 2019, p.88).
– In consideration of the contingent economic conditions of the given country, debt reduction should not require fiscal adjustments at times when it may turn out to be counter-productive (that is, leading to lower GDP and higher unemployment).

It should be mentioned that a shift of focus from year-by-year deficits to medium- to long-term debt sustainability, while taking into account the cyclical position of the economy, has already occurred with the Fiscal Compact, alas increasing, instead of reducing, the complexity and opacity of the previous apparatus of rules and their implementation.[16] This hardly promotes compliance with the rules. The quest for more simplicity, transparency and efficacy with regard to the rules is now widely shared (CEPR, 2018, 2019; Darvas et al., 2018; Tooze, 2019). The kernel of the EFB proposal is the introduction of a single indicator of fiscal performance: a ceiling on the growth rate of net primary expenditures over three years, such that public debt reduction is allowed. This indicator satisfies simplicity, observability and room for fiscal stabilisation when needed.[17]

The time also seems ripe to contemplate the so-called »Golden Rule« on public fixed net investment expenditure (Truger, 2016; EFB, 2019). Such a rule should also be included as to relax the expenditure ceiling, in order to protect net public capital growth, which has often been the escape goat of fiscal consolidation and the perfect example of having pro-cyclical together with growth-defeating policies.

The second, widely acclaimed, pillar is a plan to build up a **common fiscal capacity for the euro zone** (not necessarily the EU) with three much wanted ends:

(i) improving **both economic and financial stabilisation** in each member and the euro zone as a whole;
(ii) providing for a strategy of **parallel sharing and reduction of risks** (see Section 6);
(iii) **downsizing the dimension of national competences and budgets,** thus easing their control and compliance with the rules.

A decade after the outbreak of the financial crisis there is little dispute about this. The debate is on the details, which of course matter the most. First of all, the size of this common fiscal capacity. If it is to be lower than 1–2per cent of euro-zone GDP it will be far short of its stabilisation target.

A now shared view is that the first building block of such a common fiscal capacity should be a European (or euro-zone) **unemployment insurance scheme** funded by each member state in proportion to its GDP, along the lines discussed in detail by Beblavý, Lenaerts, (2017) and Dullien, Fernández et al. (2017) and supported politically by German Finance Minister Olaf Scholz, and also present in the Mission Letter to the new Commissioner-designate for the Economy.[18] With such a scheme only cyclical changes in unemployment (beyond a given threshold) would be financed by the euro-zone or EU fund. Countries that in bad times receive more than they have contributed should scale up their contributions when recovery is under way in order to pay back the fund and ensure that no permanent transfer between countries takes place.

Another prominent component of the euro-zone budget should be **public investment,** as again the Mission Letter to the new Commissioner-designate for the Economy puts it starkly: ›You will coordinate the launch of the future **Invest-EU programme** and ensure it contributes to our overall objectives, notably on climate neutrality and the digital transition. Building on this approach, you will also set up and implement the **Sustainable Europe Investment Plan**‹.[19] The mechanism of the Junker plan should be recon-

investment, while safeguarding fiscal responsibility‹ (Ursula von der Leyen, Mission Letter, Commissioner-designate for Economy, Brussels, 10 September 2019, p. 4)

15 Especially, we might add, in a world in which real long-term interest rates on debt seem to have permanently fallen close to zero (Blanchard, 2019).

16 The current system of the Excessive Deficit Procedure is problematic in many technical respects that we cannot address here. Suffice it to mention that, while public opinion has slowly become familiar with the idea of the limit of 3 per cent of the deficit/GDP ratio, and possibly accepts it, the Commission may now open an Excessive Deficit Procedure against a country with a deficit below the 3 per cent limit because it nonetheless violates the stricter limit of its Medium Term Objective (MTO) in terms of a ›structural budget‹. This is computed by a complex algorithm that seeks to take into account the cyclical position of the economy (a ›negative output gap‹ grants a discount) and the speed of reduction of its public debt. Unfortunately, ›while the structural budget balance is a nice theoretical concept, it is not observable and the estimation is subject to massive errors‹ (Darvas et al., 2018). Moreover, this procedure is still pro-cyclical due to the fact that the crucial variable used to correct nominal budgets in order to calculate structural ones (the output gap) is itself not observable and its estimations are frequently revised. Such estimations in turn depend on another unobservable variable, namely potential output, whose estimation appears to be strongly path dependent. To put it simply, potential output follows actual output, which means that a country experiencing a long recession may end up with little output gap, and hence small or no room for fiscal stimuli.

17 If nominal GDP falls (short of its expected potential growth rate), public expenditure growing at an exogenous rate would push aggregate demand, while tax revenues would fall roughly in proportion to nominal GDP. The resulting deficit would be counter-cyclical and expansionary.

18 ›You should lead work on the design of a European Unemployment Benefit Reinsurance Scheme to protect our citizens and reduce the pressure on public finances during external shocks, working closely with the Commissioner for Jobs‹ (p. 5).

19 Ursula von der Leyen, Mission Letter, Commissioner-designate for the Economy, Brussels, 10 September 2019, p. 5; original emphases.

sidered in order to provide a firmer and stronger jump-start to the Plan. The programme should also be designed in such a way as to prevent national bureaucracies and national rules from hindering and deleting the implementation of the Plan. Once again, some transfer of sovereignty to a supranational institution should be envisaged.

The final key – and critical – arm of common fiscal capacity, which covers a broad range of proposals, comprises **backstops against systemic financial crises**. Paradoxically, this is the area – the so-called Banking Union – in which the reform process first started amid the crisis, but political negotiations have put it on a slow track. Paralysing controversies concern the ›details‹ of the two main institutions, on which general agreement exists in principle: a **common deposit insurance,** and a **›European Monetary Fund‹**. This is the area in which mistrust matters the most, and challenges political will and leadership. As economists, we have already explained why integrated capital markets bring systemic risks, systemic risks necessitate systemic safeguards, and risk-sharing and risk reduction should proceed in parallel (Section 7.3).[20]

The third pillar of fiscal reform is **coordination of national fiscal policies and a common fiscal stance vis-à-vis monetary policy**. Saying that this would jeopardise the ›sacred‹ independence of the Central Bank is uninformed (see Section 5), especially because it is the Central Bank itself, in line with the ›new conventional wisdom‹, that is demanding more active and coordinated fiscal policies in order to overcome the limits of monetary policy in the face of today's challenges (ECB, 2019). The definition of a fiscal stance for the euro zone and individual member states should be at the heart of such fiscal policy coordination (Bénassy-Quéré, 2016; Boone and Buti, 2019), in order to make the euro-zone fiscal framework more symmetrical.

8.3 BETTER RULES ARE NOT ENOUGH

›Fixing the euro needs to go beyond economics‹ (Delatte, 2018). New common institutions are necessary. Key to overcoming the mistrust that permeates the euro-zone reform process is finding the **right institutional model** within which the reformed euro zone should be framed (Delatte, 2018; Andreozzi and Tamborini, 2019). This, in our view, should consist of a supranational upgrade towards **sovereignty sharing**. That is, neither further sovereignty devolution to technical entities which are supposed to mechanically enforce rules, nor extensions of the disorderly intergovernmental approach that took hold during the crisis (Bastasin, 2015; Fabbrini, 2015; Wyplosz, 2014).

In the ›prisoner's dilemma‹ logic that we recalled in Section 7, it is understandable that changes in the status quo are not endorsed by governments (in the northern euro-zone countries) whose public opinion seems to feel that the existing rules protect their interests and shield them against misbehaviour by foreigners (the southern euro-zone countries). However, it should also be understood that, beyond theoretical reasons, further devolution of sovereignty to purely rule-based, technocratic policymaking will never be endorsed by governments whose public opinion believes that once-and-for-all rules may be against their interests. ›Legally stronger processes are unlikely to have strong effects on national sovereign decision-makers‹ (Efstathiou and Wolff, 2019). Rules are guidelines, not substitutes for institution-based policies, because a complex construction such as the euro zone cannot be governed by means of rules alone.

Cooperative policies should be envisaged vis-à-vis **political control,** which should be retained and exerted by (representatives of) national governments. The creation of a **›European Minister – or better, a Ministry – of Economy and Finance‹** therefore seems consistent with the reform proposals examined so far (EU Commission, 2017). A lot of stumbling blocks still stand in the way, however. The two principal matters are how this new body is appointed and what mandate and powers it will have (see Asatryan et al., 2018, for an overview). Anyway, such an innovation requires a clear commitment by all parties to create genuine supranational policymaking institutions with transparent democratic legitimacy (that is, members backed by a national political mandate), general rules as guidelines and controlled and disciplined scope for discretion.

20 Eventually, if risk reduction is a dangerous *ex post* policy once the *ex ante* prudential polices have failed, a sensible approach seems to be to recognise the *crisis legacy problem*. A proposal that follows this approach is the so-called PADRE (Paris and Wyplosz, 2014). As in the aftermath of wars, the first imperative is to ›clear up the mess‹. History teaches that it is hardly possible to build new and solid institutions and relationships on the ruins of a disaster (compare the different courses of history taken by the winners after the First and Second World Wars).

9

CONCLUSIONS

We have surveyed the different views of the northern euro-zone countries and the southern euro-zone countries about the euro zone's dismal economic performance after the financial crisis and the economic policy mistakes that led to double-dip recession and a recovery that came to nought. We also discussed some suitable amendments of euro-zone governance in general in order to strengthen the institutions and to correct and simplify the rules so as to prevent future crises from making the collapse of the euro zone possible or even likely.

We have shown that neither the northern euro-zone countries nor the southern euro-zone countries represent the true story of the euro zone's malaise, nor the possible ways out. We have argued that taking the Maastricht 2.0 avenue (more stringent and more automatic rules; market discipline; greater power to non-political councils and boards) is not the right way. We embrace the confederal way. Larger areas of sovereignty should be shared and transferred to politically accountable Community (federal) institutions in order to manage a common fiscal capacity with the purposes of (i) stabilising the euro-zone business cycle and (ii) spurring environmentally sustainable growth.

Overall, the euro zone is caught in a maze of peculiar regulations not because it fails as an Optimal Currency Area – as some American economists would say – but because it fails as an ›Optimal Federal Area‹. Everyone was aware of this original sin from the very beginning, and with great regret one may say that the hope that the creation of the monetary union would pave the way to other federal institutions has so far been in vain.

Reforming the euro zone is not going to be a one-shot affair. As in any endeavour of ›high politics‹, a unique combination of vision, determination and brinkmanship is needed. Genuine reformers should nurture mutual trust. Hence, in the first place, all European citizens should be informed that reforming the euro zone is definitely not doing a favour for rule breakers. It is a favour for us all because our ›common house‹ is unlikely to withstand the next storm that is rising all around us. Second, the ›democratic deficit‹ of the European institutions in general should be taken very seriously. Last but not least, genuine reformers will need the credible determination to present all other players with a clear-cut alternative: either a serious reform is begun here and now, with all the necessary ingredients – some that the *South* dislikes and some that the *North* dislikes – or everyone will have to take their own share of responsibility for saying ›no‹ to a genuine and sustainable European Economic and Monetary Union.

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CRISIS AND REFORM OF THE EURO ZONE. WHY DO WE DISAGREE?

A reflection paper on the North–South divide

There is general agreement that reforms of the euro-zone architecture are necessary, ideally aimed at fostering further integration on the grounds of (at least) economic policy and governance.

The narrative of the crisis is decisive. Suspicion runs high and mutual trust runs low between the southern and the northern European euro-zone countries. And neither the northern euro-zone countries nor the southern euro-zone countries can account for the full story of the euro zone's malaise, not to mention possible ways out.

Better rules are not enough, new common institutions are necessary. Reform of the euro zone should be based on a confederal and cooperative model. Larger areas of sovereignty should be shared and transferred to politically accountable Community (federal) institutions in order to manage a common fiscal capacity with the purposes of stabilising the euro-zone business cycle and spurring environmentally sustainable growth.

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