

Explaining the Euro Zone Crisis: A Fable or merely Organizations without the Adequate Institutions?

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Abstract

After the beginning of the euro area, countries in its periphery engaged in weighty borrowing from foreign private investors, allowing domestic spending to outpace incomes. Consequently, those countries have faced debt crises reflecting a loss of creditor confidence in the sustainability of their finances from which results an abrupt end in private foreign lending to those economies. The debt crisis made evident the asymmetry between core and periphery countries, which is visible in trends in saving, consumption and investment. These divergent patterns have contributed to view the debt crisis as a problem of the PIIGS (Portugal, Ireland, Italy, Greece, Spain) that can be contained in the periphery, or as a new version of the fable of the ‘Grasshopper and the Ant’. We dispute this reductionism showing that the debt crisis is systemic and thus it must be explained using the main components of a system, which are organizations and institutions. Therefore, solution for the Euro Zone crisis cannot be found with more fiscal rules and austerity in peripheral countries alone. It will imply, if not an increase in fiscal and political integration, at least a higher coordination at the political and economic front and a new governance structure.

Keywords: Euro zone, EFSF, ESM, Fiscal rules, Institutions, Organisations, PIIGS, Systemic crisis.

Jel Codes: E44, E62, F15, F34, F36, F55, G01.

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1. Introduction

Euro area debt crisis has not a fiscal origin, although the policy used to bring it to an end has transformed it in a public-debt crisis. Indeed, the euro crisis has three components. The first one is a banking crisis that resulted from excessive leverage in both the public and private sectors; the second one is the sharp fall in confidence in Eurozone governments and the third is the structural imbalance between the Eurozone's core and periphery¹. This is the most dangerous factor, which menaces not only the peripheral countries but also the entire Euro Area. Solving the first two problems is a key condition to avoid a deep depression in Europe; however it cannot keep away from lost decades of economic growth if the third factor is not conveniently addressed. Although periphery's governments and the EC (European Commission) try to push the responsibility to the formerly governments for the lack of competitiveness in the periphery, it is clear that the process by which Europe periphery became uncompetitive has more deep reasons.

The structural imbalance between the Eurozone's core and periphery is visible through several trends. The divergence in saving, which is also mirrored in consumption trends, shows that the euro area periphery households responded to lower interest rates, occurred after the Euro inception, by borrowing and spending. In fact, Irish real consumption expenditure increased approximately 55 per cent from 1999 to 2007, and in Greece and Spain, the comparable figure was roughly 35 per cent (Higgins and Klitgaard, 2011). On the other hand, Germany appears as the most frugal: consumption share remained essentially stagnant after 2001, leaving the country with ample funds to lend abroad. These divergent patterns in consumption and investment contributed to view the debt crisis as a behavioural problem of the PIIGS (Portugal, Ireland, Italy, Greece, Spain) that can be contained in the periphery or as a new version of the fable of the Grasshopper and the Ant². This reductionism is disputed in this paper. The analysis

¹ Or north and south, or PIIGS and non-PIIGS

² The analogy is simple: governments of some countries (grasshoppers) have had bad behaviour: They have irresponsibly spent too much, and save too little, from which results unsustainable debt levels. They are now broke owing to their own mistakes. There is no reason to assist them. The assistance only gives them encouragement to persist in negligent behaviour. We should avoid that ants (taxpayers of core frugal countries) have to pay the bill.

of the crucial cause(s) of private and public indebtedness reveals a range of issues, whose origins should not be found in the behaviour of periphery countries alone. On the contrary, the euro crisis must be attacked as a systemic crisis whose origin can be found in the lack or maladjustment of institutions.

However, the attitude that has been prevailing among EU officials and national governments is based on different principles: bad behaviour and moral hazard as the basic ingredients of the above mentioned fable. So, the therapy adopted for both solving the sovereign debt crisis by increasing the confidence on EU periphery governments and minimizing the structural imbalance between the Eurozone's core and periphery has relied on a combination of fiscal austerity with wage compression and labour market reforms.

Our paper argues against the idea that the crisis is basically a national problem and, as so, that it must be solved by country specific measures, which was clearly the understanding of the EU authorities when crisis start in Greece. Although now, outside the EU officials and national governments circles, there are few doubts that the crisis is an essentially systemic phenomenon that affects the entire EU, the mentioned officials and governments insist that they have used the adequate therapy and that the positive signals of recuperation are abundant but insufficient because the treatment is not yet completed. Quite the opposite our paper shows that the continuation of the same therapy will aggravate the crisis. In fact, the crisis calls for a supranational solution and only the building of institutions with a supranational objective can overcome the problems that the EMU is facing. So, the remainder of the paper is organized as follows. After exposing some concepts associated to an institutional approach in section 2, section 3 links the lack of competitiveness in periphery and the structural imbalance between core and periphery with maladjustments in institutions. Section 4 deals with the loss of two important institutions in periphery: the external devaluation capacity and the control over the currency. Section 5 shows the difficulty of imposing a new organization, the EMU, without the institutions that can support it. Section 6 expose two strategies for solving and minimizing the coordination failures and negative externalities that affect the Eurozone: a first best solution, which consists on completing the EMU, and a "second best" solution of small steps. Finally, section 7 concludes.

2. Organizations and institutions

An institutional approach to explain social phenomena uses extensively the concept of institution. There is not a unique concept of institution, even within each

type of institutionalism “old” and “new” (Hodgson, 1998), perhaps because the New Institutional Economics (NIE) is a young field (Voigt, 2013) or because “institutionalism does not seek a general theory of everything” (Hodgson, 1998: 174). For the purpose of this paper it is important to distinguish the “players” from the “rules of the game”, which implies discriminate organizations from institutions as the main components of a system. We assume organizations as formal structures consciously created with an explicit purpose. They are players or actors. On the other hand, as the majority of scholars in “new institutional economics”, we assume a “rules of the game” concept of institutions: they are sets of common habits, routines, established practices, rules, or laws that regulate the relations and interactions between individuals, groups and organizations (Edquist and Johnson 1997). That is, institutions are ‘the humanly devised constraints that shape interaction’ (North 1990: 3). In human exchange, institutions structure political, social, or economic incentives. This definition of institution comprises implicit constraints, formal rules, and enforcement mechanisms. According to North, any formal rule is at least partially supported, supplemented, or contradicted by a number of implicit rules that can take the form of taboos, customs, traditions, codes of conduct, routines, conventions, and so forth (1990: 83).

If institutions are composed by sets of rules, laws etc., this doesn’t mean that all sets of rules, laws etc. should be named institutions. We only consider institutions the rules that obey to three main characteristics (North, 1990; Acemoglu et al., 2005; Glaeser et al. 2004; Voigt, 2013): (1) they structure incentives in human exchange; (2) they constrain behaviour; and (3) they are permanent or stable. Building institutions is a long term process and so a simple rule resulting from an ad-hoc arrangement cannot be considered an institution. However, it can enter in the institution category as it is gaining capacity to incentive or to restrain individual behaviours in a stable way.

Of course institutions are not immutable they evolve along time and can be substituted by others. However, the substitution process is neither quick nor instantaneous. This characteristic distinguishes the institutional approach from the structural reforms perspective. According to the latter it is possible to make reforms, changing existent rules from which result unequivocal changes in incentives that propel economic growth. The basic motivation of the structural reforms approach is to substitute quickly the actual economy by an ‘ideal’ economy without unbalances and lock-ins. Current advocates of such approach in the European Union use the EFC

(Expansionary Fiscal Contraction) hypothesis³ as theoretical support. The EFC view is based on the traditional assumption of mainstream economics that reducing government expenditures will lessen crowding out ‘making room for the private sector to expand’. As stated in Pessoa (2014), the conditions for EFC operating in peripheral countries do not exist actually: not only crowding out, which only happens when the economy is near full employment, but also a significant currency devaluation and sufficient liquidity in order to current disposable income does not restrain consumption are at odds with the real conditions in periphery countries. But without taking in account this aspect and contrarily to many research concluding that smooth and gradual fiscal consolidations should be preferred to frontloaded or aggressive budget contractions (e.g., Baum *et al.*, 2012; Batini *et al.*, 2012), especially for economies in recession⁴ facing high risk premia on public debt, the European authorities opted by a frontloading approach (quick and large spending cuts) and by the so called structural reforms.

An important question is about the change of institutions. For instance, in peripheral countries the currency devaluation was during decades the normal way of solving problems in external balance. The entrance to the EMU and the adoption of the euro as the single currency makes the external devaluation unfeasible. However the EU officials together with national governments consider that external devaluation can be substituted by structural reforms that engender an internal devaluation. As we will see in section 4, this is not a succedaneum of external devaluation. Finding a succedaneum of an institution is not a rapid process: It will be necessary a long time span for the appearance of institutions that can dispense external devaluation in periphery countries. The incapacity of understand this explains why the adopted policy has aggravated the crisis in the periphery countries instead of solving it.

But, it explains also the volatility of the financial market behaviour in relation to the EU periphery countries. In fact, financial markets considered that once these countries enter in a new organization (joined the monetary union) the value of

³ The *Expansionary Fiscal Contraction* (EFC) also known as the ‘expansionary austerity’ hypothesis (Giavazzi and Pagano, 1990) predicts that, under certain restricted circumstances, a major reduction in government spending that changes future expectations about taxes and government spending will enhance private consumption, resulting in overall economic expansion. The authors did not provide a model for EFC but rather described conditions under which it was observed in Denmark from 1983–84 and Ireland from 1987–89, a period when the world was undergoing rapid interest rate declines and world wide growth.

⁴ Baum *et al.* (2012) call attention to the need to consider that the position in the business cycle affects the impact of fiscal policy on output. If the phase of the cycle is not considered both the cuts in government spending and the revenue multipliers give results very different from the expected.

investments in these countries would no longer be vulnerable to erosion through currency depreciation. Consequently, considering the disappearance of the exchange risk, the interest rates paid by the periphery countries fell sharply resulting from this evolution an incentive for foreign borrowing by both the public and private sectors and a discouragement for saving. Here the banking system has had a decisive action channelizing the savings of core countries towards the credit in peripheral countries. As the incentive to the foreign borrowing was not the result of new institutions, when the effects of the financial crisis come in Europe via bank system, liquidity is cut down. This decrease in liquidity, together with some political events (the announcement by arriving Greek government that the fiscal budget deficit for 2009 was far larger than previously estimated) call the attention to other risks possibly affecting peripheral countries. Consequently, a crisis in confidence in periphery governments was added to the banking crisis resulted from the global financial crisis, and interest rates began to rise abruptly.

The crisis in confidence was aggravated owing to some inconsistency of the institutional design of the EMU, as results from the Treaty on European Union (TEU). Looking at the TEU we see contradictions between some of its programmatic articles: while article 3 (paragraph 3) specifies that the EU (including the EMU) “shall promote economic, social and territorial cohesion, and solidarity among Member States”, the article 125, paragraph 1, of the same Treaty, stipulates the well-known “no bail-out clause”, which in fact forbids this solidarity⁵. Also the uncountable meetings of the Council announced as decisive to solve the crisis but always demonstrating inconclusiveness contributed to increase the doubts about the future of periphery countries and the prospects of the Euro.

3. Institutions, structural imbalance and the lack of competitiveness in periphery

The European authorities have supported the option by strong austerity and structural reforms mentioned above not only based on the irrational faith on the expansionary austerity but also by other reasons. A moral justification is among them: the ants (people of core countries) worked hardly while grasshoppers (typical of periphery) were singing and dancing; now is not fair that ants pay the wasting. However, this fable is wrongly told. In fact, the lack of competitiveness in European

⁵ The rescue packages that the troika put together for Greece (May 2010), Ireland (December 2010), and Portugal (May 2011), suspended the “no bail-out clause” in reality.

periphery is the result of rational actions facing market signals and has been maintained by the incapacity of building the needed institutions for taking positive and coordinated policies in Europe, particularly within the euro area.

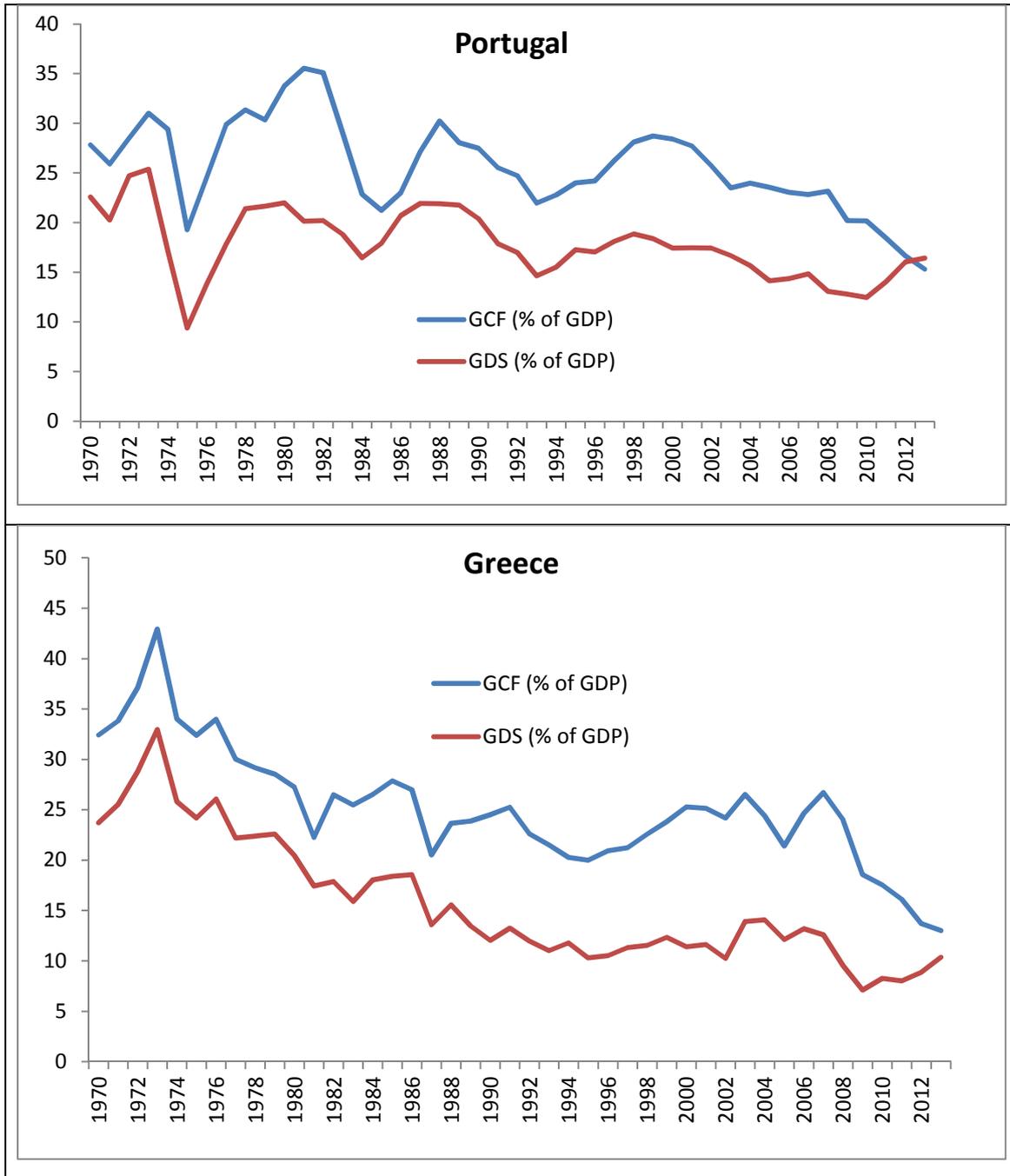
The process by which southern Europe became uncompetitive is the result of market price signals. Indeed, it was not only the incentives those signals produce on economic agents' behaviour but also the responses that individually rational entrepreneurs played out in macroeconomic terms that generated an unbalanced structure in the EZ. But this unbalanced structure results also from the disrespect of an implicit rule that generated an economic structure marked by excessive savings in core countries. The banks of these countries with money to invest were willing to lend on extraordinarily easy terms to those in the periphery who wanted to spend, and abundant pre-2007 spending made domestic demand increase there and raising wages quickly. In fact, underlying the unbalance structure is a different investment / savings pattern in core and periphery.

Some periphery countries, as is the case of Portugal and Greece, have a long tradition of investing more than saving⁶. As shown in figure 1, both Portugal and Greece have experienced chronically higher investment rates (measured by Gross Capital Formation) than domestic saving rates. Contrasting with these countries some others as Luxembourg and the Netherlands have showed persistently saving rates higher than investment rates. But there are two other groups of countries: a third group that have interchanged periods of insufficient savings with excess of savings over investment rates (Italy, France) and a fourth group (Germany, Austria) with a balanced pattern until the end of the 1990s and a clear excess of savings over investment after this date.

After the Euro inception, while Portugal and Greece have continued with the same savings / investment pattern, some core countries changed their patterns. This means that core adapted to the periphery pattern and the Euro Area adopted itself an economic configuration in which periphery wage, price, and productivity levels made sense only so long as it spent roughly more 7 to 8 percent that it earned, with the core countries financing this difference. Complementarily, core countries adopted wage and productivity levels that made sense only as long as they spent less than one euro for every euro that they earned.

⁶ Although Spain has shown a similar pattern after 1998, before this date the saving / investment ratio was more balanced.

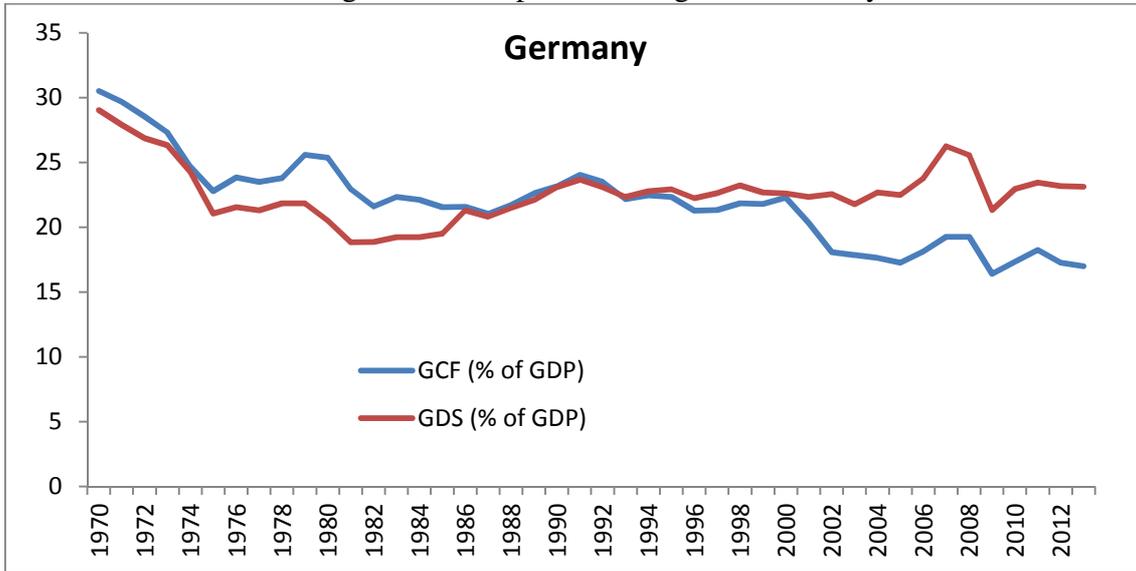
Figure 1.
The persistent imbalance between savings and investment in some periphery countries



Source: based on WDI.

Figure 2 shows the change of the savings / investment pattern in Germany. Before the entrance of Portugal and Spain in the EU, Germany shows a rate of investment higher than the savings rate. It was the time of the “German miracle” of the former German Federal Republic. From this time to the euro inception the savings roughly equated investment, but after the creation of the EZ the rate of gross domestic savings went largely beyond the gross capital formation.

Figure 2.
Saving/investment pattern changed in Germany



Source: based on WDI

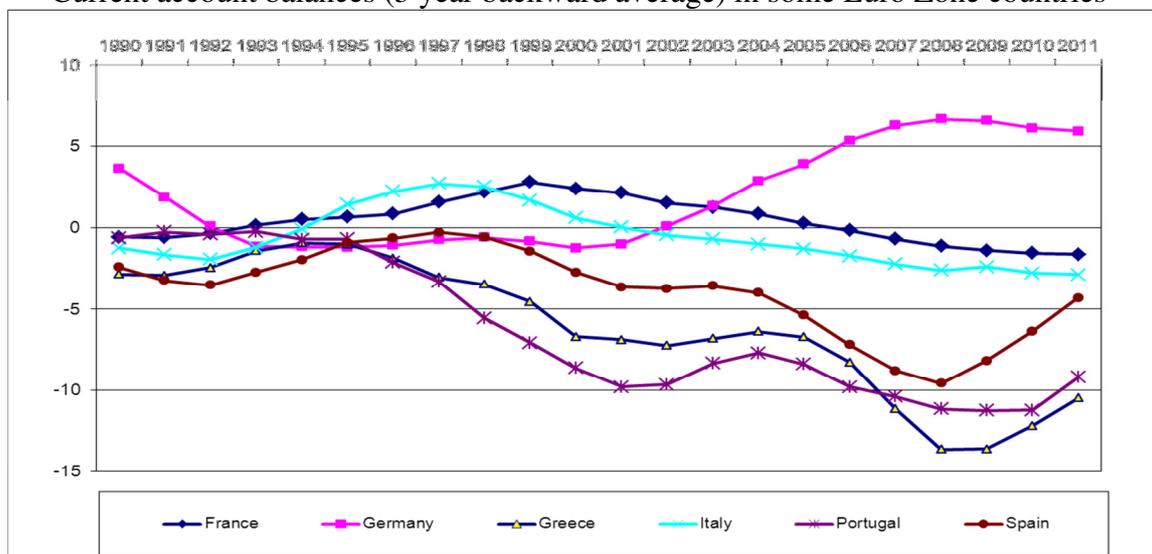
But, the change in German' savings / investment pattern was partly the result of the disrespect of an implicit rule. As it is known, in a monetary union national wage trends are the key determinant of the real exchange rate among its member economies. To avoid disturbance in intra-regional competitiveness positions, national wage trends need to follow an implicit rule (see equation 1), which is: the increase in wages (\hat{w}_i) must equate the sum of national productivity growth (\hat{y}_i) with the agreed union-wide inflation rate (\hat{p}_u), which was defined by the ECB (European Central Bank) as "below but close to 2 per cent".

$$\hat{w}_i = \hat{y}_i + \hat{p}_u \quad (1)$$

This "2 per cent rule" was not felt by the different countries as an institution. As a consequence, countries in the periphery deviate from this norm by excess, whereas Germany, the economy with the largest trade surplus within the euro area, also ignored that implicit norm, but in a downward direction: Germany modified its former incomes policy adopting a policy of maintaining constant ULC (unit labour costs). As a result, over time Germany experienced cumulative competitiveness gains in comparison with its European partners, especially in relation to the countries in the periphery (TDR, 2006, 2010; Flassbeck, 2007; Bibow, 2006). It was this change in the incomes policy,

together with some changes in the international division of labour, that was detrimental to the intra-euro area equilibrium.

Figure 3.
Current account balances (3 year backward average) in some Euro Zone countries



Source: Based on WDI.

Looking at figure 3, which displays the current account balance in percentage of GDP, from 1990 to 2011, three points deserve mention: first, the disequilibria in current accounts increase after the introduction of the Euro; second, the surplus of Germany contrasts with the large deficits of Portugal, Spain and Greece in the four years before 2008; third, the surpluses verified in France and Italy in the 1990s were followed by a decreasing trend and increasing deficits in the subsequent decade. Given that EZ is a closed economy (about three quarters of trade is done between members) the solution for disequilibria must be found inside the EZ as a whole.

Now, at least apparently, European core countries do not want that periphery spend more than it earns. If this is so, for we don't lament a generation of "lost" decades and progressive discredit in European integration, wages, prices, and productivity must shift and the periphery productivity levels need to rise relative to the core countries. Accordingly, given the cumulative distortions from the euro inception on, for periphery can pay its standard of living with exports and core economies can spend their earnings on those products, wage and price levels need to adjust by approximately 30%. If European authorities are interested in preserving the euro, and in avoiding progressive disintegration, five policy options could be used: (1) Periphery could rearrange its

business sector to become an engine of productivity; (2) Periphery could make an internal devaluation and so enforcing deflation; (3) Periphery could embark in strong austerity and so reducing its taxes and social services substantially; (4) Core countries could accept higher inflation (an extra two percentage points for five years would take care of one-third of the total core-periphery adjustment); (5) Core countries could expand social democracy by making their welfare states more generous.

The first option would be wonderful, but it cannot be attained in the short run. If anyone knew how to bring the periphery's business sector up to the productivity levels of the core countries quickly, it would have happened already. The preference of both European authorities and governments of the core countries goes to the second alternative combined with the third option. However, this is the least prudent, for it implies lost decades of stagnation and perhaps the EU collapse.

So we are left with the last two options or a combination of them with the third alternative. If Euro Area is to be maintained and it does not adopt some arrangement of the last three options as policy goals over the next years, it will face a severe choice: either lost decades for periphery (and perhaps core countries, as well) or persistent one-sided core-periphery payments that will have to be funded through fiscal transfers. Of course citizens of peripheral countries would prefer the option 4 or 5, but a balanced combination of the three latter options could be a good cooperative solution that will avoid a race to the bottom. Obviously, this will require the construction of institutions that progressively complete the EU architecture which imply to develop the economic and political integration instead of bureaucratic governance and ad-hoc arrangements.

4. The loss of institutions: external devaluation capacity and control over the currency

As above mentioned before joining the EMU the periphery countries could have relied on a weaker currency to boost exports and to support growth while undertaking the external adjustment. With the exchange rate no longer available as a correction mechanism, the EU officials together with the EU national governments consider that external devaluation can be substituted by structural reforms that engender an internal devaluation. One set of adjustment policies focuses on the dimension of the public sector, including some automatic stabilizers of the welfare state, and on fiscal austerity measures. The national governments and European organizations (Commission, Council) see in fiscal austerity some advantages: contraction measures are simple to

recognize, they punish the grasshoppers and consequently they calm the market distrusts. Unsurprisingly, these measures make the current economic welfare worse.

However substituting the devaluation of the currency by engendering an internal devaluation, i.e. bring down wages and prices relative to those of the competitors is not a solution for periphery countries, which lost competitiveness from 1999 to 2008. Although austerity measures in the peripheral countries may reduce intra-area current-account imbalances through income compression, they will also aggravate the debt and may also worsen the underlying solvency problem. Since these policies have negative effects on economic growth they will first lead to a recession and thus (through the operation of the automatic stabilizers) to increases in budget deficits. As countries experience increasing budget deficits while they attempt to improve their competitiveness, financial markets are likely to get nervous.

Periphery countries have not only lost the possibility of using the exchange rate as a correction mechanism through the depreciation of the currency they also lost control over another institution the currency in which they issue debt (De Grauwe, 2011). Some economists were already pointing out the mistake of switching national monetary sovereignties by a politically-independent central bank without any kind of political integration (Dahrendorf, 1997; Échinard, 1999). It is now evident that the control over currency is important for explaining the different nature of a debt crisis between members and non-members of a monetary union⁷.

Members of a monetary union issue debt in a currency over which they have no control. It follows that financial markets acquire the power to force default on these countries. This is not the case in countries that are not part of a monetary union, and have kept control over the currency in which they issue debt. These countries cannot easily be forced into default by financial markets. That is why a monetary union has a significant potentially destructive dynamics (De Grauwe, 2011): Members of a monetary union are much more vulnerable to liquidity movements than non-members. In fact, when creditors fear some payment difficulty (e.g. owing to a recession that leads to an increase in the government budget deficit), liquidity is sudden stopped (moved out the national market). If the country gets on austerity measures to improve competitiveness through deflation, distrust may install itself. This initiates a vicious

⁷ Comparing Spain with the UK, De Grauwe (2011) states that the creditors' distrust leads to an equilibrating mechanism in the UK and to a potentially disequilibrating mechanism in Spain, and concludes that "in a monetary union, countries become vulnerable to self-fulfilling movements of distrust that set in motion a devilish interaction between liquidity and solvency crises" (De Grauwe, 2011: 5).

circle that transforms a liquidity emergency into a solvency crisis. Once a member country gets entangled in a liquidity crisis, interest rates are pushed up. Creditors can then claim that they were right to pull out the money from that national market. There is here a self-fulfilling prediction: the country has become insolvent because creditors fear insolvency.

This vicious interaction explains why the period during which member countries try to improve their competitiveness is likely to be painful and tumultuous: Painful, because of the recession and the consequent increase in unemployment; tumultuous, because during the adjustment period, the country can be beat by sovereign debt and banking crises. If the latter occurs, the deflationary spiral is inevitably intensified. In that case the domestic long term interest rate increases dramatically, forcing the authorities to apply even more budgetary austerity which in turn leads to an even more intense recession. The banks that are trapped in a funding crisis reduce their credit to the economy. As a consequence the country finds itself trapped in a bad equilibrium, characterized by austerity programs that fail to reduce budget deficits because they lead to a downward economic spiral and punishing interest rate levels. This means that the path towards recovery for members of a monetary union is about to be crisis-friendly.

The contrast with non-members that have the capacity to issue debt in their own currency is evident. When these countries have lost competitiveness, they will typically try to restore it by allowing the currency to drop in the foreign exchange market. This makes it possible not only to avoid deflation, but also to avoid a sovereign debt crisis. As we have seen earlier, these countries' governments cannot be forced into default by generating a liquidity crisis. What is more the whole adjustment process involving currency depreciation is likely to boost output and inflation, thereby improving the solvency of the sovereign. In fact, the country solvency doesn't depend only on the debt burden (i.e., the debt to GDP ratio) but also on the difference between the nominal interest rate and the nominal growth rate as is visible in condition (2).

$$s \geq (r - g)D/Y \quad (2)$$

Where s is the primary budget surplus to GDP ratio, r is the nominal interest rate, g is the nominal growth rate of GDP, D is the government debt and Y is the GDP.

Once in a recession, members of monetary union find very difficult, if not impossible, to use automatic budget policies to stabilize the business cycle. A recession

leads to higher government budget deficits; this in turn leads to distrust of markets in the capacity of governments to service their future debt, generating a liquidity and solvency crisis; the latter then forces austerity programs in the midst of a recession. In the case of a non member country this does not happen because the distrust generated by higher budget deficit activates a stabilizing mechanism.

The automatic stabilizers in the government budget constitute important policy instruments in the developed world as they alleviate the pain for many people created by the breaks in economic activity of capitalist societies. If a monetary union destroys these automatic stabilizers, it is uncertain if the social and political basis for such a union can be maintained. It is therefore imperative to design a governance structure that preserves these automatic stabilizers.

5. Euro zone: an organization without adequate institutions

The European Union has limited fiscal responsibilities. The public finances are above all a task of the national level, and the EU level basically covers regional funds, agricultural subsidies and administrative costs financed by contributions of member states. The introduction of the euro didn't change this type of fiscal governance although theoretically a single currency should imply a single fiscal structure. However, to implement a single fiscal structure is not now, as it was not in past, an easy task. In past the consensus didn't exist, as it is visible by the discussions of decentralization and design made before euro be introduced as the EMU currency (Persson et al., 1997; Mueller, 1997). In fact, although most contributors to the debate about the EU fiscal institutions disputed the adopted design for EMU (e.g., Oates, 2001), there was not a consensual view among researchers about how fiscal structure should be. While some authors strongly defended the centralist model (Berglof *et al.*, 2003; Tabellini, 2003), others considered that the EU already has 'gone too far' in centralization (Alesina and Wacziarg, 1999). But now, as well as in the past, the fundamental reason for the inexistence of a supranational fiscal structure is, above all, the aversion of national governments to lose sovereignty. Without norms constructing a supranational fiscal structure the budgetary discipline of Member States is directed by institutions that pre-existed the novel organization: the EMU. Of course there are some supranational rules: the rules established in the Stability and Growth Pact (SGP), but these are not yet authentic institutions given their arbitrary nature (Wyplosz, 1991; Buiter et al., 1993;

Pasinetti, 1998) and the lack of a credible enforcement mechanism (Rossi and Dafflon, 2012).

Without a single fiscal structure linked to the EMU, the EU fiscal policy involves multi-level public finance arrangements, with a lot of delays and inefficiencies. However, the absence of such structure allows the EU officials to attribute the responsibility of the crisis to the lack of fiscal discipline of national governments. Although the matter of fiscal discipline is absent in fiscal theory, the empirical literature has addressed the issue discussing three features of the institutional architecture in federalist systems (e.g., Rodden *et al.*, 2003; Dafflon, 2002): fiscal disparities, excessive government and the concern for opportunistic behaviour of some sets of countries. Earlier research was concentrated on the experience of the US states (von Hagen, 1991; Bayoumi and Eichengreen, 1994; Alesina and Bayoumi, 1996; Bohn and Inman, 1996), but since middle 1990s the focus of the analysis was transferred to Europe (e.g., von Hagen and Eichengreen, 1996).

The bulk of empirical research about institutions and fiscal discipline is concentrated around the effects on risk and costs of debt (Eichengreen and Bayoumi, 1994). Two main conclusions result from this research: (1) the association between better institutions and lower risk premia; and (2) institutional characteristics of the fiscal process determine government bond yields (Hallerberg and Wolff, 2008; Poterba and Rueben, 1999; Johnson and Kriz, 2005)⁸. However, the effectiveness of national fiscal rules with respect to fiscal performance is not assured. It has been shown to depend on the type of the rule and on the mechanisms established to enforce conformity with the rule (Inman, 1996; Ayuso-i-Casals *et al.*, 2009). In this respect, expenditure rules appear to be less effective than budget balance and debt rules (Debrun *et al.*, 2008). However, all in all, empirical evidence is not fully conclusive in what respects to know if national fiscal rules serve as a commitment strategy to successfully induce the governments not to pursue short-term and pro-cyclical budgetary policies (Debrun and Kumar, 2007; Debrun *et al.*, 2008), or whether they merely have a signalling function on eliminating the information asymmetries between government and the electorate, without changing the behaviour of governments (Debrun, 2007).

⁸ Other institutional characteristics of fiscal governance were empirically investigated: existence of independent fiscal institutions (Debrun, 2007); the quality of medium-term budgetary planning frameworks and degree of budgetary transparency (Beetsma *et al.*, 2011); the impact of constitutional controls on the cost of debt (Bayoumi *et al.*, 1995).

Let's look now to the Stability and Growth Pact (SGP) of the EU. This pact translates the mere nominal convergence of the so-called Maastricht criteria. It sets out the implementation requirements for looking not only at the overall medium-term orientation of fiscal policy in its preventive arm but also at the way in which excesses over the Treaty values are treated as part of the EDP in its corrective arm. The preventive and corrective arms of the SGP were expected to ensure that countries maintained an underlying fiscal position in terms of their MTO (medium-term budgetary objectives) close to balance or surplus, thereby ensuring that the absolute deficit did not exceed 3% of GDP in recession and the debt was brought rapidly below 60%. Although Commission always placed countries under the Excessive Deficit Procedure (EDP) when their deficits exceeded 3% of GDP, they were never sanctioned for their lack of fiscal discipline. In 2009 and 2010, the Council applied the corrective arm of the SGP to almost all EU Member States. Greece, Latvia, Lithuania, Romania, Malta, Poland, Bulgaria, Denmark, Belgium, the Czech Republic, Germany, Italy, France, Spain, Ireland, the Netherlands, Austria, Portugal, Slovenia, Slovakia, Cyprus and Finland were placed under the EDP, while Hungary and the United Kingdom had their prior recommendations revised. In 2010, the Council gave notice to Greece to take measures to correct its excessive deficit by 2012. In practice, even in pre-crisis years few countries were at their MTO. So, it is evident that the EU rules of the SGP have limited effect in preventing excessive deficits, particularly in recession periods.

Furthermore, the debt criterion was never explicitly enforced. Specifically, the EU legislation that implements the requirements of the EDP does not provide any condition about the execution of this criterion (European Commission, 2011). While this absence does not legally exclude the possibility that countries could be placed in EDP for high levels of debt, it makes more politically difficult to do so. Curiously, there is no EU rule about the current account deficit although this has played a critical role in the Greek and Portuguese cases.

The above examples show that the SGP was never taken seriously as an institution. On the contrary, it makes appear an ingenious and widespread creative accounting "to cook the books" of the public sector across the aspiring EMU countries when the relevant entry test was to be carried out (see Dafflon and Rossi, 1999) and after that (Martinuzzi, 2010; Story, Thomas, and Schwartz, 2010), as well as leading to

significant creative accounting aimed at overcoming them (von Hagen and Wolff, 2006; Buti *et al.*, 2006)⁹.

Instead of recognizing that the low credibility of the SGP results from the low level of political integration, the EU officials insist in considering that the problem is the way the rules are applied and not the nature of the rules. Accordingly, they want more restrictive fiscal rules and that they should be stipulated in national constitutions. However, the problem is not that countries are reluctant to cut their deficits decisively enough. Even with constitutional amendments, one just cannot think that legislation takes away macroeconomic realities¹⁰. So before introducing in Constitution fiscal rules of uncertain result, the EU, and forcefully the EMU, should increase efforts to build an institutional framework that propels the EU development as a whole. These efforts should drive Europe towards more political integration rather than the increasing of the bureaucratic controls.

6. Coordination failure and negative externalities

a) The “first best solution”: completing the EMU

Two problems of the EMU governance require government action. First, there is a coordination failure. Financial markets can drive countries into a trap resulting from a self-fulfilling mechanism. This coordination failure can in principle be solved by collective action aimed at orienting countries towards equilibrium. Second, the Euro zone creates externalities (mainly through contagion) and similarly to what happens with all externalities, public intervention should consist in internalising them.

Both collective action and internalisation can be taken either at the level of the central banks or at the level of the government budgets. Given that non-member countries can avoid liquidity crises principally because the sovereign can force the central bank to provide it with all the necessary liquidity, a similar solution can also be attained in the EMU if the ECB is willing to buy the different sovereigns' debt. In fact, this is what happened in the Euro zone during some periods of the debt crisis. The ECB bought government bonds of distressed member countries, either directly or indirectly

⁹ Bernoth and Wolff (2008) highlight the impact of hidden policy activity, creative accounting practices, and transparency of government budgeting on sovereign spreads in the euro area.

¹⁰ Spain and Ireland, two of the crisis countries, had run budget surpluses over much of the late 2000s, and both the OECD and the European Commission had praised their sound public finances during that time. However the recession in Ireland and Spain were so deep and the deficits suddenly so large that no constitutional rule would have been able to prevent those deficits. Macroeconomically, it just would not have been possible to quickly bring down the deficits to the balanced position.

by accepting these bonds as collateral in supporting their banks. In this way, the ECB re-channelled liquidity to countries affected by a liquidity crisis, and prevented the centrifugal forces created by financial markets from breaking up the Euro zone. In fact, if the purpose of the central bank is to preserve the monetary union, this is the right policy. However, the ECB has been heavily criticized for acting in this way. As a consequence of this censure, the ECB has trying to limit its intervention and has recommended that the assistance should be done instead by other institutions, such as an EMF (European Monetary Fund). Acting in this way the ECB gave a wrong message to financial markets. This wrong message was well visible until the current governor has told that he will make everything to save Euro¹¹. The correct action should imply that the ECB is available to a limitless intervention in the market. This is the only behaviour that is adequate to a central bank.

Collective action and internalisation can also be taken at the budgetary level. Ideally, the proper instrument of collective action and internalisation is a budgetary union. If national government budgets are consolidated into a central budget it is possible to organize an instrument of automatic transfers that works as an insurance mechanism relocating resources to members affected by negative economic shocks. In addition, this creates a new organization; a common fiscal authority that can issue debt in a currency controlled by that authority. Doing so, the budgetary union protects its members from being forced into default by financial markets. But, above all, it protects the monetary union from the centrifugal forces caused by the financial markets.

The most radical way to break the vicious circle resulting from the disequilibria in financial markets would be to introduce Eurobonds. National risk premia would then disappear, and German savers would have no problem investing their savings in the Euro zone's periphery, knowing that the German government would ultimately endorse these countries' government bonds. The Euro zone economy could then recover quickly (De Grauwe, 2011; Juncker and Tremonti, 2010). However, the introduction of Eurobonds has been criticized too: it would create huge incentive problems (Issing, 2009), because debtors in the Euro zone periphery would no longer have to fear any punishment by markets and might thus be induced to enforce their grasshoppers' behaviour, consuming and investing excessively.

¹¹ Unsurprisingly, after this statement interest rates began to decrease. The decrease was more visible after 2012, September 6, when ECB announced its program of OMT (Outright Monetary Transactions). It is worth noting that the abrupt decrease of interest rates was obtained without any spending of ECB. The announcement was sufficient to calm financial markets.

Of course, this “first best” solution requires an effort of creating institutions that will lead to a far-reaching degree of political union. While economists have stressed that such a political union will be necessary to sustain the monetary union in the long run (European Commission, 1977; De Grauwe, 1992), it is obvious that there was no willingness in Europe at the time where crisis have occurred, and also nowadays, to significantly increase the current degree of integration. This aversion to go on the direction of more political union will continue to make the Euro zone a “fragile” construction (De Grauwe, 2011).

b) The “second best” solution: small steps

Since there are not conditions to follow the above strategy, one can consider a “second best” one: a path made of small steps. Such an approach not only would allow solving the most immediate problems, but also would signal the sincerity of European authorities in moving forward in the direction of more political union. Given the current reluctance in going towards a higher degree of integration it only appears as viable for Euro zone to follow this “second best” solution. The debt emergency has forced European leaders to implement new bodies capable of dealing with the crisis. The creation of the EFSF (European Financial Stability Facility) in May 2010 was the most impressive response. It was transformed into a permanent European rescue fund, the ESM (European Stabilization Mechanism), inaugurated on 8 October 2012, which will provide loans to countries in difficulties and constitutes the permanent crisis resolution mechanism for the countries of the euro area. This step goes in the direction of a new organization: a European Monetary Fund, as was first proposed by Gros and Mayer (2010), in order to provide bridging finance when capital markets break down¹². But even the creation of an EMF cannot save the Euro zone economy if trust between core and periphery countries goes down. Surely these were important steps that were necessary to maintain the stability of the Euro zone. Nevertheless, the opposition against these decisions continues to be high especially in Northern European countries.

Although important steps these instruments have many drawbacks. The levels of former interest rates and collective actions clauses have prevented these instruments from being succeeded in stabilizing the Euro zone. In fact, the high interest rate applied by the EFSF in the rescue programs of peripheral countries has had very adverse effects.

¹² The EMF will be a mechanism that lets the capital market function most of the time, but that makes possible to intervene when market closes down.

First, by charging this high interest rate it made it more difficult for the government of the stressed countries to cut their budget deficit and to slow down debt accumulation. Second, by charging a high spread above the risk free rate that the core country's governments undertaken, the EFSF signalled to the market that there was a significant risk of default, and thus that the government of peripheral countries might not succeed in solving the budgetary disequilibria. So, it is essential that the ESM can take a more clever approach in lending to distressed countries than the EFSF previously did.

Another small step was given with the new European banking union arrangements. The banking union would make a systemic banking crisis less likely and would help bring down financing costs in the euro periphery. However, the current form of the proposed banking agreement fails the objectives policy makers had set for a banking union. It is both not sufficient to provide a proper framework to deal with new systemic crisis, and unable to level the playing field between banks in different Eurozone countries. Although with these arrangements "the financial system in Europe will be much more stable" the extent to which banking union can level the playing field in the European market for financial services remains limited. "While the improvement will be significant, it will not be complete" (Dullien, 2014).

The above steps of the "second best" solution have functioned as a policy of "the stick and the carrot" (De Grauwe, 2011). The stick is the conditionality, i.e. an austerity package for punishing grasshoppers, the carrot is providing an interest rate that makes easier to stop the debt accumulation. A low interest rate demonstrated confidence in the success of the package, which is fundamental to induce financial markets to buy the government debt at a reasonable interest rate. However, it appears that the EU officials only use the carrot as an ultimate resource. Although the initial intention of ESM to apply an interest rate that is 200 basis points above its funding rate has been considerably sweeten with lower amount of margin and fees, it is an unfortunate fact to consider such penalty. There is no good reason for the ESM to apply a high interest rate except for punishing bad behaviour. But applying such a risk premium, the ESM will signal to the market that it does not truly believe in the success of its own lending programme. This is not an intelligent action because in doing so the ESM is also diminishing the chance of be paid in future.

There are other features of the ESM that will undermine its capacity to stabilize the sovereign bond markets in the Euro zone. From 2013 on, all members of the Euro zone are obliged to introduce "collective actions clauses" when they issue new

government bonds. Although the intention may be good, the effect will be negative (see De Grauwe, 2010). In fact we have already seen the effects. When the German government made the first proposal to introduce collective action clauses at the European Council meeting of October 2010, the immediate effect was to intensify the crisis in the Euro zone sovereign bond markets (De Grauwe, 2011). All this is quite unfortunate, especially because the existence of a financial support mechanism in the Euro zone is a significant step forward in the building of an integrated Europe (Peirce *et al.*, 2011). Unfortunately, by introducing all kinds of restrictions and conditions, the ESM has been transformed into an instrument that is unlikely to produce more stability in the Euro zone.

7. Conclusion

The euro crisis highlights the dangers of large disparities in a monetary union. This paper argues that for understanding why the crisis appears as an endless problem both the lack of adequate institutions and the maladjustment between organizations and institutions must be taken in due account. The establishment of a new form of economic and monetary integration, the EMU, should be accompanied with more political integration. Only this will be capable of creating and developing the institutions suitable to the new organization.

With an independent national currency, policymakers can use currency depreciation to obtain quick gains in competitiveness, replacing foreign borrowing — at least in part — with higher export revenues. The attempt of substituting the loss of this institution by a combination of structural reforms and fiscal austerity contributed for aggravating the crisis. The idea is to engender an internal devaluation, reducing the dimension of the public sector, including some automatic stabilizers of the welfare state. The threat, however, is that failure to achieve sustained productivity gains would leave adjustment to occur only through lower wages and slower growth in domestic consumption and investment spending. Given the systemic nature of the crisis, the decrease in prices in periphery spills over the rest of the Union and now deflation in the EU is more than a possibility.

Since members of a monetary union have lost much of their capacity to apply counter-cyclical budgetary policies, they can be forced into a bad equilibrium, characterized by deflation, high budget deficits and a banking crisis. It is evident that

with this scenario it is impossible to recover the markets' confidence. But the correction in the periphery countries would occur with a reduced pull on living standards and more easily if the EU countries do agree that the euro crisis is not a problem of bad behaviour but on the contrary the result of a succession of errors in the construction of the EMU aggravated by the therapy applied in periphery countries..

The euro survival needs more economic and political integration. But, in spite of the integration rhetoric is increasing in European political circles, neither a “first best” nor a “second best” solution appears to be sufficiently wanted by the EU governments and officials. In practice the “second best” solutions proposed go towards more bureaucratic controls instead of political integration. There is no reason to let euro implode, but this will inevitably happen if the lack of willingness in changing policy and in advancing political integration persist. From May 2010 to nowadays is time enough for solving the crisis. It is outside of our comprehension that Euro zone cannot put an end on it, unless because the EU officials are fascinated in proving either unrealistic theories, as the expansionary austerity, or the moral superiority of ants over grasshoppers.

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