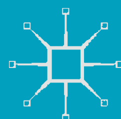
EUROPE IN CRISIS

A Structural Analysis

Edited by
Leila Simona Talani



Europe in Crisis

Leila Simona Talani
Editor

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A Structural Analysis

palgrave
macmillan

Editor
Leila Simona Talani
King's College London
London, UK

ISBN 978-1-137-57706-1 ISBN 978-1-137-57707-8 (eBook)
DOI 10.1057/978-1-137-57707-8

Library of Congress Control Number: 2016953833

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The registered company is Macmillan Publishers Ltd.
The registered company address is: The Campus, 4 Crinan Street, London, N1 9XW, United Kingdom

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1

Introduction: Europe in Crisis: A Structural Analysis

Leila Simona Talani

The contributors to this book share the belief that the sovereign debt crisis affecting the Eurozone periphery has been the consequence of the structural asymmetries characterising the process of European monetary integration and the Economic and Monetary Union (EMU) from its onset, exacerbated by the impact of the global financial crisis.

Moreover, there is some agreement that European institutions were taken by surprise by the financial crisis and as yet do not seem to have the capacity, nor the political will, to truly move forward in the necessary process of political and fiscal integration.[1]

The European Commission, in particular, was completely unprepared to tackle the global financial crisis and the subsequent recession. Indeed, European responses to the financial crisis have been fairly erratic and ad-hoc,

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[1] Soedeberg, S., (2010), *Corporate Power and Ownership in. Contemporary Capitalism: The Politics of Resistance and Domination*, London: Routledge.

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L.S. Talani (ed.), *Europe in Crisis*,
DOI 10.1057/978-1-137-57707-8_1

and European Union (EU) authorities did not seem capable of providing a solid safety net for struggling countries in the periphery. Furthermore, European Institutions may be considered at least partially responsible for the effects of the Global financial crisis on the Eurozone. For example, in the period preceding the crisis, the European Central Bank (ECB) was not particularly active in curbing the expansion of the financial sector in general and, in particular, of powerful Western European banks, which as a result became heavily exposed. As some of the contributors in this book clearly point out, the Commission seemed to be much more interested in the flexibility of the labour markets (Talani in Chap. 6), while the financial sector deregulation continued unhindered.[2] Equally, there was no EU coordination of macroeconomic policy responses to the ensuing economic crisis. When and if stimulus programs were implemented, this happened merely at the level of the nation state and usually brought accusations of 'financial protectionism' in breach of the single market and in support of national economic players at the expense of their European competitors. Finally, the EU relied heavily on the International Monetary Fund (IMF) to provide much needed support for Europe's periphery.[3]

Where does all this leave the euro? When the Eurozone was established, there was much talk about the euro becoming an international reserve currency, challenging the international role played by the US dollar. Although the international role of the euro had increased somewhat in the 10 years following its introduction, the dream of further expansion did not materialise and for very good reasons judging from the latest developments in the EU. Indeed, the little improvement in the international position of the euro took place at the beginning of the EMU and until 2002–2003, and it is mainly due to the substitution effect with the German currency. Anything happening thereafter was mainly the consequence of the appreciation of the European currency vis-à-vis the US dollar, although it might be more appropriate to talk about the depreciation of the dollar with respect to the euro. Obviously, all progress in this respect has been reversed with the outburst of the global financial crisis

[2] Cafruny, A., (2010) "The Global Financial Crisis and the crisis of European neo-liberalism", in Talani, L.S., (ed.) *The Global Crash*, London: Palgrave, pp: 121–140.

[3] Cafruny, A., (2010) "The Global Financial Crisis and the crisis of European neo-liberalism", in Talani, L.S., (ed.) *The Global Crash*, London: Palgrave, pp: 121–140.

to the extent that, as further elaborated in the Chap. 2, the dollar even gained the status of a "safe haven" for investors during those troubled times. Finally, the Eurozone crisis definitely ended any aspirations of the euro to further develop into an international currency given the instability not only of the economic policy making of the EU, but also of its political and ideological framework.[4]

There is speculation that the policy decisions taken by the EU in response to the Eurozone crisis are configuring a new institutional project in line with a neo-functionalist interpretation of the crisis as almost a stimulus for further integration of the European economic governance system. This is also reflected, to a certain extent, in some of the contributions to this book (Torres and Bongardt in Chap. 3). However, paradoxically, the USA, where the crisis first exploded and where its economic consequences where first felt, managed to come out of the global financial and economic crisis much stronger than Europe, in monetary terms, but also in economic and political ones, thus making any previous discussion about the capacity for the EU to take the lead in the global economy frankly obsolete and meaningless.[5] To be sure, in the USA there were institutions, such as the US Federal Reserve and Treasury able to adopt the necessary crisis-management measures as well as to take up the role of lenders of last resort, whereas in the case of the Commission and of the ECB this was clearly not the case (Talani in Chap. 2).[6]

Finally, after the events in Greece, as very well detailed by Fouskas and Dimoulas in Chap. 6, there is really little evidence of European solidarity; on the contrary there is much evidence of the incapacity of the EU to intervene in a coordinated way to avoid disaster.

Indeed, reaction to the sovereign debt crises affecting the so called PIIGS group (Portugal, Ireland, Italy, Greece and Spain) mainly took the form of ad-hoc measures lacking institutional depth and, more importantly, democratic legitimacy, such as the European Financial Stability Facility

[4] Plashcke, H.,(2010), "Challenging the Dollar in International Monetary Relations? The lost opportunities of the Euro", in Talani, L.S., (ed.), *The Global Crash*, London: Palgrave, pp: 73–100.

[5] Plashcke, H.,(2010), "Challenging the Dollar in International Monetary Relations? The lost opportunities of the Euro", in Talani, L.S., (ed.), *The Global Crash*, London: Palgrave, pp: 73–100.

[6] Cafruny, A., and Talani, L.S, (2012), "The consequences of the global financial crisis on Europe", *International Political Economy Yearbook*, Volume 18 Boulder: Lynne Rienner.

(EFSF)[7] later replaced by the European Stability Mechanism (ESM).[8] Neither of the institutions come any closer to the establishment of a much needed fiscal union in the EU that would finally guarantee true solidarity among the member states. Even less useful to this aim are the many changes and addenda to the Stability and Growth Pact, taking the form of the Fiscal Compact and of the Six-Pack, which resulted in a newly reformed Stability and Growth Pact. On the contrary, far from providing a platform for a real fiscal unification, they fuelled discontent amongst the populations of peripheral countries bashed by the austerity mantra and, above all, practice. Indeed, there is little doubt in the minds of the contributors to this book that the burden of the costs of the crisis was inflicted on the weakest sectors of the EU society. This happened through the imposition of savage austerity plans justified by the EU institutions' rhetoric on 'internal devaluation' as the only way out of the crisis when it would have been necessary to seriously tackle the democratic and solidarity deficit affecting the EU system. It is no surprise, then, that similar austerity plans resulted in popular resistance, political instability and eventually in the threat of disruption to the EU integration process as a whole.

Thus, in this book, the crisis of Europe and especially of its periphery is analysed within the context of the structural asymmetries of the EMU with the aim to identify the impact of the crisis on the future of the EMU and of the EU project as a whole.

To start with, in Chap. 2 Talani argues that the global financial crisis acted as an asymmetric shock for the Euro Area. This is due to the structural differences characterising the different Euro Area member states, structural differences that both the adoption of the euro and the onset of the global financial and economic crisis contributed to, deepening a structural problem of competitiveness embedded in the way in which the EMU was devised and implemented. This is contrary to the widespread belief that the Eurozone crisis was the necessary consequence of the unsustainability of the fiscal position of the peripheral members of the Eurozone. Talani points, instead, at the lack of sustainability of a structurally asymmetric

[7] See http://www.efsf.Europa.eu/about/index.htm as accessed on December 15, 2010.

[8] For more details, see http://www.consilium.Europa.eu/uedocs/cms_data/docs/pressdata/en/ec/118578.pdf, as accessed on December 21, 2010.

EMU in the wake of an extremely serious economic shock, the global financial crisis. Unable to tackle the real problems of the Euro Area and intervene to increase political and fiscal integration, the EU institutions' insistence on 'internal devaluation' and austerity only brought the PIIGS group to the verge of the abyss.

In Chap. 3, Annette Bongardt and Francisco Torres provide a different perspective on the crisis by focusing on the role of economic and structural reform in EMU. Starting out with the uneven governance of EMU's economic and monetary parts set out in the Maastricht blueprint, they examine how soft coordination under the heading of the Lisbon Strategy fared before the sovereign debt crisis and proceed with analyzing the changes that the eruption of the sovereign debt crisis in 2010 brought about, looking into the Europe 2020 Strategy, the Euro Plus Pact, and the implications of the emergence of market pressure and conditionality. The chapter focuses on structural reform needs from the point of view of a durable crisis exit. In this context the authors also discuss the special case of Greece. They conclude that EMU – or at least the membership of individual countries - will not be sustainable without creating national adjustment capacity and willingness to implement economic reforms. Although EMU resilience could still be guaranteed through other mechanisms in the absence of sufficient national adjustment capacity (notably abanking union with an orderly state bankruptcy regime), this would mean a very different model of European integration.

In Chap. 4, Stefan Collignon introduces a completely new approach to the notion of competitiveness and the related lack of it plaguing the Eurozone periphery. Overturning the idea that a monetary union functions essentially like a fixed exchange rate system, just much stronger, he proposes to view a currency union like a domestic economy, with a single domestic debt which, therefore, can be serviced out of profits in the non-tradable sector and not only by export earnings. As a consequence, a currency union only needs balanced growth between the sectors and between regions (countries). From this standpoint, competitiveness is no longer a measure of comparative advantage in foreign trade, but simply a measure of profitability for investment. In his chapter, Collignon proposes a new index for measuring the competitiveness of wage levels which is based on the return on capital in the Euro Area.

Chapter 5, By Alex Turk and Gianni lo Schiavo, discusses the new regulatory tools for the European Banking Authority and argues that such tools, while increasing the efficiency of the financial market regulation, pose a risk to the constitutional and institutional foundations of the EU. The Union's constitutional and institutional framework provides normatively important limitations to the conferral of powers to agencies resulting front the principles of conferral (legal basis constraint), institutional balance (delegation constraint) and democratic legitimacy (process constraints). It is argued that the drive for greater efficiency in the regulation of financial services undermines these important constraints. This view has obvious implications for the interpretation of the legal provisions providing for such tools.

In the second part of the book the contributors see the crisis from the point of view of the periphery.

Chapter 6, by Fouskas and Dimoulas, counters the mainstream view that the Eurozone crisis emanated partly from the incompetence of the peripheral EU states to collect taxes, partly from their own states' profligacy with a huge and uneconomic public sector, and partly from the 'fact' that these societies are not working as hard as their northern neighbours. This view has been defeated by original work carried out in the past few years not only by Marxian scholars and heterodox economists, but also by important financial commentators and journalists, such as Martin Wolf of the *Financial Times*. The Eurozone crisis, this winning approach argued, is a balance of payments crisis that is bound up with Germany's anti-inflationary, low wage, export-led growth creating permanent surpluses for itself and permanent deficits for the periphery. This chapter goes a step further by offering a historical reading of the Greek social and political economy; it brings into context political and agential aspects of the crisis, that is, a class analysis of the Greek situation. The thesis advanced is that Greece's dominant capitalist class has always been a comprador one, which, from the early 1990s onwards, began diversifying its main activities following the global trend of financialisation and the insertion of Greece into the Eurozone. It is argued that this class and its politico-ideological ramifications constitute the most parasitic and corrupt element of Greek society and politics that any left alternative has to confront head on.

In Chap. 7, Talani analyses what went wrong in the relationship between Italy and the EMU. Although Italy was amongst the most enthusiastic founding members of the European Economic Community in 1957, the Italian capacity to respect the imperatives of European integration could not, and still cannot, be taken for granted, as the recent sovereign debt crisis demonstrates. Apart from the many structural inconsistencies that persist not only in the economic, but also in the political and social organization of the country, the public debate is sometimes characterised by a tendency to blame the process of Europeanisation for the less palatable decisions taken by the national institutions.

This chapter addresses the sub-national, national and supranational dimensions of the process of Italian Europeanisation, focusing in particular on the role of domestic socio-economic actors in influencing monetary policy decision and its link to the implementation of policies of flexibilisation of the labour markets culminating in the recent adoption of the so called 'Jobs Act' by the Renzi administration.

Chapter 8 by Giusti and Tajoli deals with the case of Poland. The World Bank economist Marcin Piatkowski concluded in a recent report that Poland 'has just had probably the best 20 years in more than one thousand years of its history'. Within the EU, the country has been the most resilient to the 2008 global financial crisis. While the limited connections to the international and European financial markets is part of the explanation, one cannot overlook the role of sound macroeconomic policies set up through years in reducing the likelihood of transmission effects based on free trade, fiscal discipline and more integration at the European level. Despite its extraordinary economic performance, Poland has not yet entered the EMU. Polish leadership has mostly calibrated its economic policies following this aim but it is still very controversial in the country, both from a political (public opinion and the opposition are contrary) and a legal point of view (Euro accession would require constitutional changes). This chapter seeks to understand the motivations behind the Polish postponement of the accession to the EMU and the pros and cons (economic, political, social) of this delay. Is this limbo situation going to be a permanent one establishing a 'de-facto' opting-out from the EMU?

Chapter 9, Pascal Petit analyses the way out of the European crisis. He argues that economic stagnation is now endemic in Europe in the aftermath of the recession that followed the 2008 financial crisis. Responses to the crisis have thus far focused on financial issues. European leaders averted the collapse of banks and bankruptcy of member governments by organising emergency financial support. New frameworks for regulation of banks and other financial institutions were introduced in parallel with efforts in the USA and other high income countries. But measures to bolster financial stability have not been adequate to launch a general recovery of growth and investment in Europe. Unemployment remains high while government services and social benefits are being cut in most countries. Budget cuts have depressed spending without achieving long-term reforms in public finances. Nor have they been effective, thus far, in reducing government debt relative to GDP. Debt ratios can be expected to fall gradually but the adjustment will be a long painful process and countries in Europe will share the cost directly via depression of their trade and investment.

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Part I

The Structural Dimension

2

The Eurozone Crisis: Between the Global Financial Crisis and the Structural Imbalances of the EMU

Leila Simona Talani

2.1 Introduction

This chapter places the sovereign debt crisis of the so called 'PIIGS' group of European Union (EU) member states (made up of Portugal, Ireland, Italy, Greece and Spain) within the context of the structural imbalances characterising the Economic and Monetary Union (EMU) from the onset.

It is argued that the global financial crisis, given the structural differences of the different Euro Area members states, acted as an asymmetric shock which exacerbated a structural problem of competitiveness embedded in the way in which the EMU was originally devised and implemented. By no means was the crisis only the result of an unsustainable fiscal position in the PIIGS member states. If anything, it confirmed the lack of sustainability of a structurally asymmetric monetary union in the wake of an extremely serious economic shock. This has meant

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L.S. Talani (ed.), *Europe in Crisis*,
DOI 10.1057/978-1-137-57707-8_2

bringing the PIIGS group to the verge of the abyss, despite many voices having warned at the onset of EMU about the need for more symmetric arrangements in Europe and the development of more fiscal and political integration.[1]

This chapter addresses these issues, starting with the unfolding of the Eurozone crisis. It will then identify the structural imbalances of the EMU. Finally, it will assess the solutions that have seemingly been found to the crisis and their impact on the future of the EMU and of the PIIGS within it.

2.2 The Global Financial Crisis and the Crisis of the Eurozone

The global financial crisis was an unprecedented blow to the global economy resulting in consequences that still need to be fully appreciated.

Scholars identify five different stages in the unfolding of the global financial crisis.[2] The first stage is the collapse of the US subprime mortgage market. This spilled over into the credit market with a credit crunch that led to a third phase, represented by the liquidity crisis. The fourth phase was represented by the commodity price bubble and the fifth by the demise of investment banking in the USA.[3]

Eventually, the decision to pump an enormous amount of public money into the global financial markets averted the catastrophe. But the financial crisis had already spilled over into an economic crisis, with Ireland being the first Eurozone country to technically enter into recession in September 2008.[4] In only two years, the world as a whole

[1] See Talani, L.S., (ed), (2009), The future of EMU, London: Palgrave.

[2] Orlowski, L.T., (2008). *Stages of the 2007/2008 Global Financial Crisis: Is There a Wandering Asset-Price Bubble?*, Economics Discussion Papers, No 2008–43. http://www.economics-ejournal.org/economics/discussionpapers/2008-43 as accessed on May 18, 2009.

[3] Orlowski, L.T., (2008). *Stages of the 2007/2008 Global Financial Crisis: Is There a Wandering Asset-Price Bubble?*, Economics Discussion Papers, No 2008–43. http://www.economics-ejournal.org/economics/discussionpapers/2008-43as accessed on May 18, 2009.

[4] Sinn, H.W., (2010), *Casino Capitalism*, Oxford: Oxford University Press.

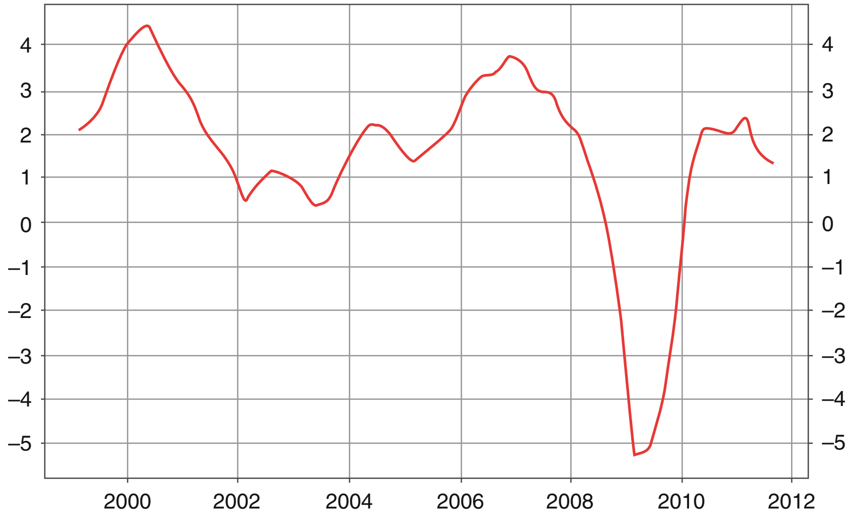

Fig. 2.1 GDP changes in the Eurozone 2000–2012 (*Source*: ECB web-site: http://www.ecb.int/home/html/index.en.html as accessed on June, 13 2012)

experienced a GDP reduction of 6 %, from 5.2 % to –0.8 %, the sharpest ever recorded in history.[5]

In the Eurozone, GDP fell even more sharply, recording an incredible loss of 9 % from 3.8 % in 2007 to –5.2 % in 2009 (Fig. 2.1).

The last phase to date in the unfolding of the crisis was the outburst of a sovereign debt crisis in the Euro Area, first in Greece, in May 2010, then in Ireland at the end of November 2010, and finally to all the members of the so-called PIIGS group.

Greece was the first casualty in May 2010. The fact that its debt had been downgraded by Moody's a few days prior did not help to avoid speculation, nor did the long time taken by other members of the Euro Area before deciding to provide a rescue package. This package included the establishment of an ad-hoc European Financial Stability Facility (EFSF).[6] Second in line was Ireland, which was plagued by the ongoing

[5] Sinn, H.W., (2010), *Casino Capitalism*, Oxford: Oxford University Press, p. 6.

[6] See BBC News, available at http://news.bbc.co.uk/2/hi/business/8671632.stm as accessed on December 22, 2010. See also below this chapter.

crisis of its banking system at the end of November 2010. Although its European partners had approved a rescue plan providing an overall €85 billion (€35 billion to bail out the Irish banking system with the remaining €50 billion to help the government's day-to-day spending), the markets insisted on increasing the yields required to buy Irish bonds (as well as Greek, Portuguese, Spanish and Italian ones).[7] Amid serious worries for the stability of the entire system, on 16 and 17 December, 2010 the European Council moved toward the institutionalisation of a rescue tool called the European Stability Mechanism, which was officially launched on 8 October, 2012.[8]

However, in December 2010 the financial and economic situation in Europe and especially in the Eurozone was heavily compromised. The main problems were found in the interplay between sovereign debt difficulties and the weakness of the banking sectors of some countries with the euro. Taken together, these issues could bring serious consequences for the sustainability of the EMU as a whole.

In its assessment of the main risks for the financial stability of the Eurozone, the European Central Bank (ECB) differentiated between sources outside the financial system and sources of concern inside it.[9] Outside the financial system, the main sources of risk for Eurozone financial stability included the possibility of new concerns with respect to the sustainability of fiscal stances in some member states; a resurgence of global imbalances; vulnerability of non-financial corporations' balance sheets; and macroeconomic problems related to the increase of unemployment and related reduction of private credit. Within the Eurozone financial system, important risks included the possibility of new strains to the financial system; more problems with banking exposure to bad debt;

[7] See BBC News, available at http://www.bbc.co.uk/news/business-11860879 as accessed on December 22, 2010.

[8] See BBC News *Q&A: The European Stability Mechanism*, available online http://www.bbc.co.uk/news/business-19870747 as accessed on October 9, 2012.

[9] ECB (2010) *Financial Stability Review* available online at http://www.ecb.int/pub/fsr/html/summary201012.en.html accessed on December 22, 2010.

and increase in the volatility of financial markets in the lack of macroeconomic recovery.[10]

The main worry that remained, however, was concerning the lack of sustainability of public finances in some Eurozone countries, which had prompted market speculation against Greece. This had already created an adverse feedback loop between lower economic growth, bank funding vulnerabilities and fiscal imbalances, as was reflected in increases in the persistently growing spread between Eurozone sovereign bond yields.[11] On the other hand, the profitability of many Eurozone large and complex banking groups (LCBGs) continued recovering in the second and third quarters of 2010, demonstrating how the banking sector had succeeded in shifting the burden of the financial crisis.[12] Finally, concerns were voiced with respect to the possibility that global financial imbalances could widen again, thus creating new strains on the fiscal and financial sectors of some Eurozone countries.[13]

Similar worries were confirmed in 2010 and 2011 when the Greek, Irish and Portuguese spreads with the German Bund hit, respectively, 1600, 1200 and 1100 basis points in July 2011. Also, the Spanish and Italian sovereign debt spreads with the Bund reached 400 basis points, Belgium hit 200 basis points and France hit 90 basis points.[14]

In 2012 the situation was still extremely worrying, with Spain having to accept a sort of bailout for its endangered banking sector of about 100 billion euros and Italy being widely considered the next in line.[15]

[10] ECB (2010) *Financial Stability Review* available online at http://www.ecb.int/pub/fsr/html/summary201012.en.html accessed on December 22, 2010.

[11] ECB (2010) *Financial Stability Review* available online at http://www.ecb.int/pub/fsr/html/summary201012.en.html accessed on December 22, 2010.

[12] ECB (2010) *Financial Stability Review* available online at http://www.ecb.int/pub/fsr/html/summary201012.en.html accessed on December 22, 2010.

[13] ECB (2010) *Financial Stability Review* available online at http://www.ecb.int/pub/fsr/html/summary201012.en.html accessed on December 22, 2010.

[14] ECB (2010) Financial Stability Review available online at http://www.ecb.int/pub/fsr/html/summary201012.en.html accessed on December 22, 2010.

[15] See Financial Times, June 13th 2012:, available at http://www.ft.com/cms/s/0/d2d42d1e-b36c-11e1-83a9-00144feabdc0.html#axzz1xfURTAr3 as accessed on June 13, 2012.

2.3 The Eurozone Crisis: A Fiscal Crisis?

Much of the blame for the sovereign debt crisis has been put on the dire situation of the PIIGS' fiscal stance. Although it cannot be denied that the countries considered were not enjoying a healthy budgetary situation, it must be noted that the policy of fiscal stimulus to combat the crisis came at a high cost for the fiscal position of many other countries. For example, the newly elected Obama administration introduced a stimulus package of $800 billion, bringing the budgetary deficit to 10 % of GDP in 2009. A similar figure was envisaged for the same year in Japan, while in the UK the deficit to GDP figure was almost 13 %. In the Eurozone, the deficit to GDP was on average only 6 % in 2010, whereas in the mid 1990s it had reached more than 7 %.[16] The situation was, of course, different in the different countries of the Eurozone. However, with respect to the case of the Eurozone periphery, two points must be stressed.

First, some of the countries which have since been affected by the most serious run on their sovereign debt were by no means performing so badly in terms of deficit to GDP in the course of the crisis. In 2010, when the attacks started, Greece had a deficit to GDP of 10.3 %, only 4.3 % higher than the Eurozone average which was 6 % at the time. Portugal and Spain with 9.8 % and 9.3 %, respectively, were just around 3.8 % and 3.3 % higher than the Eurozone average.[17] Italy had actually been doing quite well in the course of the crisis, better than the average of the Eurozone, with a deficit to GDP of only 4.6 % in 2010, which had even declined from 5.4 % in 2009. Of course, commentators then blame the Italians for having an outrageous debt to GDP ratio. However, it is worth noting that in 1995 this ratio was 121.5 % against an average of 72.5 % in the rest of the future Eurozone, whereas by 2010 the difference between the Italian performance and the average of the Eurozone had actually decreased from 49 % in 1995, to 34 %.[18] Moreover, in 2010 Spain had a debt to GDP ratio of 61.2 %, much below the Eurozone average of

[16] See ECB statistics, available at http://www.ecb.int/stats/gov/html/dashboard.en.html as accessed on October 9, 2012.

[17] Ibid.

[18] Ibid.

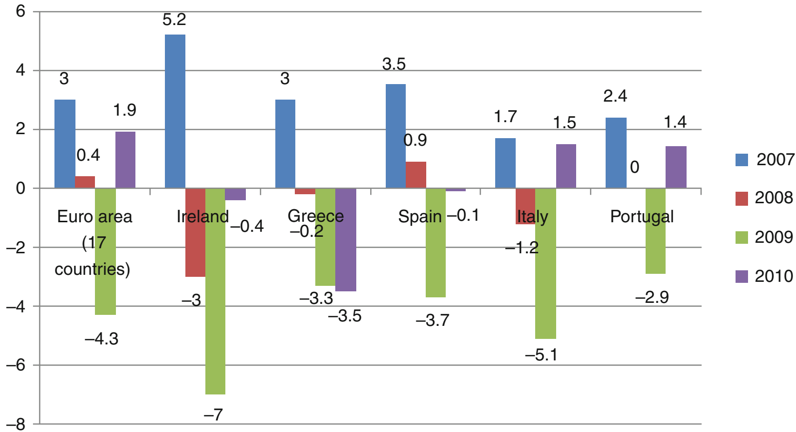

Fig. 2.2 Real GDP loss 2007–2010 (*Source*: EUROSTAT elaboration of the author)

85.2 %, and also Ireland and Portugal were not doing that badly with figures of 92.5 % and 93.3 %, respectively.[19]

Finally, similar performances of the deficit and debt to GPD ratio must be seen in the context of spectacularly declining levels of GDP which by definition, if only for mathematical reasons, increases their values. Between 2007 and 2009, Ireland lost 12.2 % of its real GDP, Greece 6.5 %, Spain 7.2 %, Italy 6.8 % and Portugal 5.3 % (Fig. 2.2).

2.4 The Global Financial Crisis as an Asymmetric Shock

In an effort to identify the relationship between the global financial crisis and the crisis of the Eurozone, it is important to ask, along with the relevant literature, two questions.[20]

[19] Ibid.

[20] See Manganelli, S. and Wolswijk, G. (2009),"What drives spreads in the euro area government bond market?", *Economic Policy*, 24: 191–240. Arghyrou, M.G. and Kontonikas, A., (2010) *The EMU sovereign-debt crisis: Fundamentals, expectations and contagion*, Cardiff Economics Working

First, are the larger spreads recorded in the course of the crisis a consequence of larger fiscal deficits and debt or do they show a change in the attitude of the markets towards the pricing of government credit risk?

Second, to what extent did the global financial crisis modify the attitude of the markets towards credit risk in the direction of more risk aversion?

The empirical results of a study conducted by the ECB shows that markets penalised fiscal imbalances much more strongly after the collapse of Lehman Brothers in September 2008, to the extent that coefficients for deficit differentials were 3–4 times higher and for debt differentials 7–8 times higher during the crisis period than earlier.[21] So, to answer the first question, the markets clearly changed their attitude towards pricing of government credit risk in the course of the global financial crisis and in its aftermath. But why did they do that? First the study underlines how there was a significant increase in bond spreads due to a general increase of risk aversion. This makes a lot of sense if we think that over the course of the crisis, the collapse of the stock exchange and of the housing market together with a general uncertainty about exposure to very risky assets of most of the banking system made it imperative to look for safe havens in which to invest. Indeed, the price of commodities such as gold and oil went up as a consequence of the general instability of other forms of investment, and this lead to a commodity price bubble which is considered in the literature as the fourth phase in the development of the crisis.[22] Also government bonds in the USA and, after the

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Paper, N. E2010/9. See also Monfort, A., and Renne, J.-P., (2011) *Credit and liquidity risks in Eurozone sovereign yield curves*. Paris: Banque de France Working Papers Series, n. 352. Haugh, D., Ollivaud, P., D. Turner, (2009) *What drives sovereign risk premiums? An analysis of recent evidence from the Eurozone*. Paris: OECD Economics Department Working Papers, N. 718. Gerlach, S., Schulz, A. and G.B. Wol (2010).*Banking and sovereign risk in the euro area*..CEPR Discussion Paper, n. 7833. Attinasi, M.G., Checherita, C., and C. Nickel, (2009). *What explains the surge in euro area sovereign spreads during the financial crisis of 2007-09?*. ECB Working Paper Series, n. 1131. Barrios, S., Iversen, P., Lewandowska, M. and R. Setzer, (2009) *Determinants of intra-Eurozone government bond spreads during the financial crisis.* Brussels: European Commission, Directorate General for Economic and Financial Affairs, Economic Papers, N. 388.

[21] Manganelli, S. and G. Wolswijk, (2009)"What drives spreads in the euro area government bond market?". *Economic Policy*, 24: 191–240.

[22] Orlowski, L.T., (2008). *Stages of the 2007/2008 GlobalFinancialCrisis: Is There a Wandering Asset-Price Bubble?*, Economics Discussion Papers, No 2008–43. http://www.economics-ejournal.org/economics/discussionpapers/2008-43 as accessed on May 18, 2009.

start of the crisis, Germany (the benchmark in the euro-denominated bond market), assumed a safe-haven investment status. Furthermore, not only were investors/markets generally more risk averse, but they were also penalizing fiscal imbalances much more strongly than before September 2008, as demonstrated by the ECB study. These two factors account for much of the spread increase for EU country government bonds relative to German or US treasury benchmarks.[23]

It is indeed remarkable that US government bonds, the country where the crisis had started and which was experiencing huge fiscal imbalances, instead of becoming more risky were unanimously considered by the markets as a safe haven in which to invest in a period of instability.

The case of Germany, however, is less puzzling. In the whole process of European monetary integration, from the establishment of the exchange rate mechanism of the European Monetary System onwards, Germany had been the '1' country of the 'n-1' problem, in other words the country with the strongest currency which could, because of the technical characteristics of the fixed exchange rate arrangement, define the monetary policy for all the members of the currency agreement.[24] More specifically, the 'n-1' problem means that in a fixed exchange rate system there are only 'n-1' independent exchange rates, and therefore, while 'n-1' countries have to use their monetary policy so as to keep their exchange rate fixed, there is always'1' country, the one with the strongest currency, which is free to set its monetary policy independently of exchange rate constraints. Moreover, by definition, the '1' country is the one with the strictest, more credible, anti-inflationary monetary policy which allows its currency to be stronger than the currencies of the other members of the Union. This, however, has evident consequences for the competitiveness of the 'n-1' countries, which experience higher inflation rates and therefore progressively lose competitiveness up to the point at which their exchange rate becomes unsustainable and the markets can successfully speculate against their currencies.

[23] Manganelli, S. and G. Wolswijk, (2009) "What drives spreads in the euro area government bond market?". *Economic Policy*, 24: 191–240.

[24] De Grauwe, P., (1996), *International Money*, Oxford: Oxford University Press, p. 27.

Although, clearly, in the economic and monetary union there is only one monetary policy and no exchange rates, first the global financial crisis and then the economic crisis made it clear to what extent the asymmetries and the 'n-1' problems that had already affected the Exchange Rate Mechanism (ERM) of the European Monetary System (EMS) persisted, and were actually much more serious, in the (EMU).

Indeed, for the 'n-1' countries joining the EMU, it meant fixing the exchange rate at a higher value than it would have otherwise been, and this is particularly true for the least competitive countries whose currencies tended to devalue more often before the establishment of the EMU—the PIIGS countries. On the other hand, the '1' country, Germany, joined the EMU enjoying a devaluation of its exchange rate which, together with the impossibility of any competitive devaluations by the other members of the EMU, progressively increased its competitiveness. What is important to underline here is that this is a structural characteristic of the EMU which was inherited from the previous exchange system but was made more serious by the fact that in the EMU there is no possibility to regain competitiveness through devaluation.

This trend is clearly visible looking at the power purchasing parity real exchange rate (RER)[25] of the PIIGS in relation to Germany based on the average consumer price index from 2000 to 2012 (Fig. 2.3).

Thus, from the start of the EMU, Germany enjoyed a structural bonus of competitiveness which increased progressively, as, indeed, had been predicted by many European Political Economy (EPE) scholars.[26] Of

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[25] The formula for the RER used here is given by:RER = e (P*/P), where e is the nominal exchange rate (1 in the case of the Eurozone), P* stands for the international prices index (in this particular case, German prices) and P is national price index. The data was obtained from the World Economic Outlook Database of September 2011, available on the IMF's website http://www.imf.org/external/pubs/ft/weo/2011/02/weodata/index.aspx. Inflation is computed with the average consumer inflation index for all countries. See http://econapproach.blogspot.it/2011/11/real-exchange-rates-and-eurozone-issues.html as accessed on December 27, 2012. For a similar analysis see European Commission, Economic and Financial Affairs (2012), Price and Cost Competitiveness, 1-2/2012, Brussels: EC, web-site: http://ec.europa.eu/economy_finance/publications/pcqr/2012/pdf/pccr_1_2_2012_en.pdf, as accessed on December 27, 2012.

[26] Talani, L.S., (2009), The future of EMU, London: Palgrave; Eichengreen, B. and Frieden, J. (1994) *The political Economy of European Monetary Union*, Boulder: Westview Press; Frieden, J. (1991) "Invested interests: the politics of national economic policies in a world of global finance", *International Organization*, 45:4, pp. 425-451; Frieden, J. (1994) *The impact of goods and capital market integration on European monetary politics*, Preliminary version, August; Frieden, J. (1998)

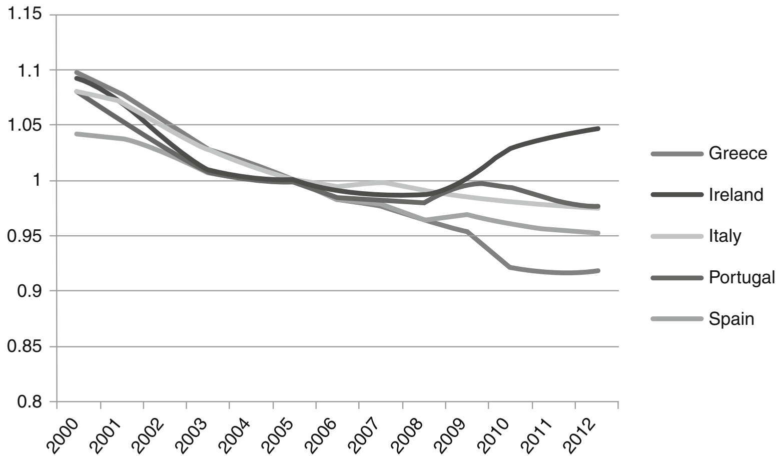

Fig. 2.3 PIIGS real exchange rates: 2000–2012 (*Source*: IMF, WEO-elaboration of the author)

course, exchange rate devaluation is considered in the economic literature as a very bad way to regain competitiveness. Much emphasis was therefore placed on what is normally referred to as 'internal devaluation', or 'supply side economics' which basically means reducing the costs of production by increasing productivity and/or reducing labour costs. Indeed, the EU approached and still approaches the whole question of growth and employment by relying significantly on labour market flexibility, the rationale of which is often neo-functionally linked to the establishment of the EMU. Furthermore, the implementation itself of flexible labour market policies was made possible by the strengthening of the bargaining power of employers' organisations, which was reflected in the institutionalisation at the European level of the neo-liberal economic paradigm focusing on the implementation of strict monetary and fiscal policies (See Talani Chap. 5 in this book).

However, despite the EU rhetoric and practice on structural reforms, these were clearly not enough to overcome the competitiveness gap

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The new political economy of EMU, Oxford: Rowman and Littlefield; Moravcsik, A., (1998) *The choice for Europe*, Ithaca: Cornell University Press.

between Germany and the weakest countries of the Eurozone (See Torres and Bongardt in this book). The global financial and economic crisis led the markets to believe that the competitiveness gaps accumulated over the years between the core and the periphery of the Union was unsustainable. Indeed, Arghyrou and Kontonikas[27] argue that the performance of the spreads in the course of the global financial crisis was due to both an international risk factor, measured by the US Stock Market Implied Volatility (VIX) and a country-specific macro factor represented by the loss of international competitiveness.

In short, both the need to find a safe haven for investment in times of uncertainty and the fact that some countries' overall macroeconomic and fiscal position was judged unsustainable because of a lack of international competiveness, made the markets believe that betting against the weakest countries of the system was safe. In the lack of national exchange rates, currency speculation was obviously impossible and the markets reverted to speculation on sovereign debt, dramatically increasing the spread between the bonds of the countries under attack and the bonds of those countries which were considered stronger, primarily Germany.[28]

Summing up, more than a shelter against the worst consequences of the global financial and economic crisis, the EMU, as designed at Maastricht and implemented in the following years proved a highly asymmetric arrangement. It signalled to the markets which countries were unlikely to sustain the economic shock, thus unleashing a run on their sovereign debt.

2.5 The Saver of Last Resort: The ECB

Given the appetite of the markets for easy sources of profits, it seems inevitable that the only real rescue mechanism for the run on the PIIGS could be the European Central Bank acting as a hidden lender of last

[27] Arghyrou, M.G. and A. Kontonikas, (2010) *The EMU sovereign-debt crisis: Fundamentals, expectations and contagion*. Cardiff Economics Working Paper, N. E2010/9.

[28] Arghyrou, M.G. and A. Kontonikas, (2010) *The EMU sovereign-debt crisis: Fundamentals, expectations and contagion*. Cardiff Economics Working Paper, N. E2010/9. Monfort, A., and J.-P. Renne, (2011) *Credit and liquidity risks in Eurozone sovereign yield curves,* Paris: Banque de France Working Papers Series, n. 352.

resort and an open 'saver' of last resort. Of course, the European Central Bank is still far from becoming the official 'lender of last resort' of the Eurozone area, something that would be more than natural in a currency union. However, in the wake of the collapse of Lehman Brothers in October 2008, the ECB started a novel mode of monetary policy relying not only on conventional measures, such as interest rate cuts, but also on 'non-standard measures'. These included 'enhanced credit support (ECS)' and 'securities markets programs (SMP)'. Such measures configured a new role for the ECB as a 'hidden/modern lender of last resort' or, as referred to in some scholarly interventions as 'intermediation of last resort'.[29] The enhanced credit support relies on (a) increasing the share of liquidity supplied at its long-term refinancing operations (LTROs) relative to its regular main refinancing operations (MROs); and (b) increasing the maturity structure of its LTROs. Most importantly, all of the ECB's refinancings would be conducted on a 'fixed-rate full allotment' basis, rather than a variable rate tender format, as used before. In other words, contrary to normal practice, financial institutions are allotted the full amount of liquidity that they want at the prevailing interest rate, which was and still is very low.

Moreover, the program allowed the Eurosystem to accept assets that had become illiquid in financial markets (notably mortgage-backed securities) as collateral in its refinancing operations. In its operations, the Eurosystem provided cash loans against the security of these assets. Finally, the Eurosystem increased the number of counterparties eligible for Eurosystem operations from 140 to around 2000 and started protecting the counterparties' anonymity to avoid domino effects.[30]

Since 2008, the ECB has successively introduced six-month, twelve-month and thirty six-month terms for LTRO finance. Each of these new issues has been heavily subscribed, with Eurozone periphery banks in Ireland, Italy, Spain and Greece taking the majority of the first thirty six-month issue in late 2011. The second thirty six-month issue was in

[29] Giannone, D., Lenza, Michele, Pill, Huwand Reichlin, Lucrezia (2011), *Non-Standard Monetary Policy Measures And Monetary Developments,* Brussels: ECB Working Paper Series No 1290.

[30] Giannone, D., Lenza, Michele, Pill, Huwand Reichlin, Lucrezia (2011), *Non-Standard Monetary Policy Measures And Monetary Developments,* Brussels: ECB Working Paper Series No 1290.

February 2012 and this one was also very successful with weaker Eurozone banks.[31]

In addition, in May 2009 the ECB announced a first €60 billion Covered Bond Purchase Programme (CBPP) to purchase euro-denominated covered bonds issued in the Euro Area over the period until June 2010. A CBPP2 started in November 2011.[32]

The second non-standard component of the ECB's response to the crisis, together with enhanced credit support measures, was the launch in May 2010 of the Securities Markets Programme (SMP). This allowed the Eurosystem to buy both private and public Euro Area debt. Given the constraints of the provisions of the Treaty on the Functioning of the European Union, Eurosystem purchases of government bonds were strictly limited to secondary markets and fully sterilised by conducting liquidity-absorbing operations. They were also capped to a weekly limit which made the appetite of the markets even greater as they knew that by overcoming the limit by just a tiny bit they could make a huge profit. However, Draghi's announcement on 6 September 2012 that the SMP was superseded by the Outright Monetary Transactions (OMT) allowing for the unlimited purchase of bonds of struggling countries in secondary markets finally stopped the financial markets from going short on the sovereign debt of the PIIGS. The ECB finally became the 'saver of last resort' by making it impossible for market speculation to run against the weakest Eurozone countries' sovereign debt. Of course, this is subject to conditionality, which implies that member states willing to benefit from the OMT have to agree to the implementation of a full or precautionary ESM macroeconomic adjustment programme. Also, the International Monetary Fund (IMF) should be involved in the elaboration and monitoring of country-specific conditionality. Moreover, the Governing Council of the ECB maintains the right to initiate, continue and terminate OMT with full discretion.[33] In addition to these measures,

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[31] See Financial Times available at http://lexicon.ft.com/Term?term=long_term-refinancing-operation-_-LTRO as accessed on October 18th, 2012.

[32] See ECB monetary policy online, available at http://www.ecb.int/mopo/html/index.en.htm as accessed on October 18th, 2012.

[33] See ECB online, available at: http://www.ecb.int/press/pr/date/2012/html/pr120906_1.en.html as accessed on October 24th, 2012.

the Eurosystem continues to provide liquidity in foreign currencies, most notably in US dollars.[34]

Most tellingly, however, after Draghi's announcement there was no need to actually implement the OMT as the markets stopped being able to make money going short on the PIIGS' sovereign debt. The run on the PIIGS stopped, although their fiscal stances are not necessarily better than when the Eurozone sovereign debt crisis first started.

The quantitative easing (QE) programme inaugurated by the ECB on 22 January, 2015 putting 60bn euros into the system a month until at least September 2016 is, on the contrary, mainly aimed at stopping deflation, not the markets from attacking the fiscal debt of the weakest Eurozone countries.[35]

2.6 A New Economic Governance System for the Eurozone?

Given the structural issues characterising the Eurozone crisis, the need for an integrated European economic governance has been advocated on a number of occasions and, in theory, enjoys the support of leading EU politicians.[36] At the European level, however, to date there is nothing like a pan-European regulatory regime for the EU and Eurozone banking and financial systems and even less likely is the prospect of a truly common fiscal policy.

[34] For a chronological listing of the measures see the Annex "Chronology of monetary policy measures of the Eurosystem" in the November 2011 Monthly Bulletin, available at http://www.ecb.int/pub/pdf/mobu/mb201111en.pdf?7e572425fb17ac05bf95689a50691ef3and for details on the ECB's non-standard measures, including a comparison with the Fed and the Bank of Japan, see "IV. The ECB's response to the financial crisis" of the former President Trichet's speech "The ECB's enhanced credit support" available at http://www.ecb.int/press/key/date/2009/html/sp090713.en.html. For details on the ECB's response to the financial crisis, see the article "The ECB's response to the financial crisis" in the October 2010 Monthly Bulletin, available at http://www.ecb.int/pub/pdf/other/art1_mb201010en_pp59-74en.pdf. For details on the ECB's response to the sovereign debt crisis, see September 2011 Monthly Bulletin, Box 5, available at http://www.ecb.int/pub/pdf/other/box5_mb201109en.pdf.

[35] See BBC web-site http://www.bbc.co.uk/news/business-30915210 as accessed on October 22, 2015.

[36] See *Financial Times*, various issues.

Of course, some steps were taken to restructure what had proved to be a highly inadequate European regulatory regime for the financial and banking sector. In terms of the redefinition of the EU approach to the regulation of the single financial market, shortly after the onset of the financial crisis in 2008 the EU Commission President Barroso gathered a group of high profile experts, headed by Jacques de Larosière, to propose a new, integrated European system of supervision. On 25 February, 2009 the group presented a report which represented the basis for the new European financial supervisory architecture proposed by the Commission in its Communication to the Spring European Council of March 2009. Further details on the Commission's plan were contained in its Communication of May 2009. These included:

1. The establishment of a European System of Financial Supervisors (ESFS) composed of a network of national financial supervisors working in cooperation with new European Supervisory Authorities (ESAs). The latter should have been created by transforming the existing European supervisory committees (Committee of European Banking Supervisors [CEBS], Committee of European Insurance and Occupational Pensions Supervisors [CEIOPS] and Committee of European Securities Regulators [CESR]) into a European Banking Authority (EBA), European Insurance and Occupational Pensions Authority (EIOPA), and a European Securities and Markets Authority (ESMA), respectively.
2. The establishment of a European Systemic Risk Board (ESRB), in charge of macrosupervision of financial stability to be effected by providing an early warning of system-wide risks. This was to be accompanied by the ability, if necessary, to issue recommendations to act against similar risks.

These proposals were discussed in the course of two open meetings. The first one, from 10 March to 10 April 2009, followed the report of the de Larosière group and the publication of a Commission Communication

on 4 March, 2009. It informed the Commission Communication on Financial Supervision in Europe published on 27 May, 2009.[37]

In the second one, from 27 May to 15 July, 2009, the Commission invited all interested parties to comment on the more detailed reforms presented in the May Communication on Financial Supervision in Europe. At this stage there seemed to be a great deal of support for the proposed ESRB and ESFS.

The transformation of the existing Committee of European Banking supervisors on 1 January, 2011 into the European Banking Authority (EBA) based in London, and the establishment of the European Securities and Markets Authority (ESMA) in Paris and the European Insurance and Occupational Pensions Authority (EIOPA) in Frankfurt created the new European Supervisory Authorities (ESAs) to be inserted in the European System of Financial Supervisors (ESFS). However, this does not seem to have substantially resolved the issue of pan-European banking and financial supervision.[38] National authorities remain responsible for the day-to-day supervision of individual firms, with the new European architecture only providing an overarching European framework for financial supervision.[39] Moreover, the ESAs themselves comprise high-level representatives of all of the member states' supervisory authorities under permanent chairmanships.[40] They have the power to temporarily ban certain high-risk financial products and activities, such as naked short selling, as well as instructing banks and other financial actors in crisis situations, drawing up standards for national regulators and settling disagreements between them.[41] However, this will be possible only in situations of

[37] A summary of the public submissions received can be found on: http://ec.Europa.eu/internal_market/consultations/docs/2009/fin_supervision/summary_en.pdf.

[38] Teixeira, P.G., (2011), "The regulation of the European Financial Market after the crisis", in Della Porta, P., and Talani, L.S., (eds), *Europe and the Financial Crisis*, London: Palgrave.

[39] For more details see http://www.consilium.Europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/117747.pdf as accessed on December 21, 2010.

[40] For more details see http://ec.Europa.eu/internal_market/consultations/docs/2009/fin_supervision_may/replies_summary_en.pdf and http://ec.Europa.eu/internal_market/finances/docs/committees/supervision/20090923/com2009_501_en.pdf As accessed on December 21, 2010.

[41] For more details see http://www.time.com/time/world/article/0,8599,2016359,00.html as accessed on December 21, 2010.

emergency to be defined by the council and it is limited by a safeguard clause attributing to the member states the power not to abide by the decisions of the ESAs.[42]

As in the Commission's plan, the new ESAs are complemented by a group connected to the Frankfurt-based European Central Bank, called the European Systemic Risk Board (ESRB). The ESRB monitors the risk of major threats to the economy, such as problems at major banks or asset bubbles.[43] Although connected to the ECB, the ESRB seems to be mainly a consultative body.

Given the shortcomings of these reforms to the EU banking supervision regime, made evident by the evolution of the Eurozone sovereign debt crisis, at the end of June 2012 the European Union leaders agreed to set up a single supervisory authority to oversee 6,000 banks in Europe, with the aim of having it in place by the end of the year.[44] The possibility of moving towards the establishment of a European banking union was supported by the European Council in its June 2012 summit.

Following this, the European Commission presented, on 12 September, three documents concerning the European Banking Union. The first was a communication proposing a general outline for a banking union, including the provision of a single rulebook and single supervisory mechanism (SSM), as well as foreseeing the establishment of a single bank resolution mechanism (SRM). The second was the proposal of a Council regulation that would allow the European Central Bank (ECB) to activate its formal role as the only supervisor of all banks in the Euro Area, providing for the option for non-Euro Area countries to enter this arrangement on a voluntary basis. Finally, the Commission proposed a regulation of the European Parliament and of the Council which would adapt the regulation of the European Banking Authority (EBA) to the new banking supervisory regime. This was intended to avoid problems of

[42] For more details see: http://ec.Europa.eu/internal_market/finances/docs/committees/supervision/20090923/com2009_501_en.pdf as accessed on December 21, 2010.

[43] For more details see http://www.consilium.Europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/117747.pdf as accessed on December 21, 2010.

[44] For the full report on the characteristics of the proposed European Banking Union see Sapir et al. (2012).

competence between the ECB and the EBA which would then remain in charge of maintaining the integrity of the Single Market.[45]

With these documents the Commission supported the idea of a European banking union that should be 'composed of a single supervision mechanism, a European deposit insurance scheme and a common resolution system'.[46]

The European Council conclusions on completing the EMU that were adopted on 18 October, 2012 reiterated the need to move towards an integrated financial framework and invited legislators to proceed with work on the legislative proposals on the Single Supervisory Mechanism (SSM) indicating the 1st of January 2013 as the deadline to agree on the legislative framework. The definition of the legislation needed for its operational implementation took place in the course of 2013. Eventually, the Single Supervisory Mechanism entered into force on 4 November, 2014 giving to the ECB the capacity to supervise around 6,000 banks in the Eurozone and in any other EU country deciding to adhere to the SSM. However, the ECB only supervises the bigger banks, while supervision for domestic banks still remains in the hands of the national central banks.[47]

Finally, on 30 July, 2014, one year after the Commission presented a proposal, the regulation establishing the Single Resolution Mechanism (SRM) for the Banking Union was published in the *Official Journal of the EU* to enter into force on the 1st of January 2016. The SRM simply implements for the Eurozone the rules already set by the Bank Recovery and Resolution Directive (BRRD) for the EU 28, allowing for the efficient resolution of both cross border and domestic banks.[48]

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[45] For the text of the three proposals see http://ec.europa.eu/internal_market/finances/committees/index_en.htm#maincontentSec1 as accessed on October 12, 2012.

[46] Sapir, A., Hellwig M., and Pagano, M. (2012), "A contribution from the Chair and Vice-Chairs of the Advisory Scientific Committee to the discussion on the European Commission's banking union proposals", in Reports of the Advisory Scientific Committee No. 2/October 2012, ESRB available at http://www.esrb.europa.eu/pub/pdf/asc/Reports_ASC_1210.pdf?490dce9cc2a2bf39b76ae4b06604b0ca accessed on October 11, 2012, p.1.

[47] See EU web-site http://ec.europa.eu/finance/general-policy/banking-union/index_en.htm as accessed on October 22, 2015.

[48] See EU web-site http://europa.eu/rapid/midday-express-30-07-2014.htm?locale=en as accessed on October 22, 2015.

2.7 The Progress of Fiscal Coordination in the Wake of the Eurozone Crisis

The progress of fiscal coordination in the wake of the Eurozone debt crisis falls far short of a real fiscal union. This initially took the form of mainly ad hoc decisions providing for impromptu solutions lacking institutional depth and democratic legitimacy, such as the EFSF.[49] A more institutionalised rescue mechanism for member states of the Eurozone under attack by the financial markets called the European Stability Mechanism (ESM)[50] was approved in December 2010.

The Economic and Financial Ministers Council (ECOFIN) Council deliberated on the establishment of the EFSF on 9 May, 2010. The total endowment of the Fund to rescue Eurozone countries in crisis was €750 billion. This included the possibility for the EFSF to issue bonds guaranteed by Euro Area Member States (EAMS) for up to €440 billion for on-lending to EAMS in difficulty, subject to conditions negotiated with the European Commission in liaison with the European Central Bank and International Monetary Fund and to be approved by the EUROGROUP. The EFSF enjoyed a triple A credit rating awarded by the most influential agencies: Standard & Poor's, Fitch Ratings and Moody's. The EFSF was, however, only a temporary arrangement.[51]

To avoid further spreading of the sovereign debt problems to other countries, in December 2010 the European Council opted for the institutionalisation of a European Stability Mechanism (ESM), which was inaugurated in October 2012 after a long and controversial ratification process.[52] With the establishment of the ESM, the EFSF started its phasing out.

The role of the European Stability Mechanism (ESM) is similar to that of its predecessor and consists of providing financial assistance to Euro

[49] See http://www.efsf.Europa.eu/about/index.htm as accessed on December 15, 2010.

[50] For more details, see http://www.consilium.Europa.eu/uedocs/cms_data/docs/pressdata/en/ec/118578.pdf, as accessed on December 21, 2010.

[51] See http://www.efsf.Europa.eu/about/index.htm as accessed on December 15, 2010.

[52] The ESM Treaty entered into force on 27 September, 2012. All seventeen euro area member states had ratified by 3 October, 2012.

Area member states experiencing financial problems. The funds used by the ESM to achieve its aims are raised by issuing money market instruments as well as medium- and long-term debt with maturities of up to 30 years. These assets are backed by capital provided by the EAMS according to the contribution key annexed to the ESM Treaty.[53] Whether the funds raised by the ESM would be enough to cover the refinancing needs of big EAMS in difficulty, such as Italy and Spain, and therefore stop market speculation, is debatable.[54] To be sure, the ESM is supposed to cooperate closely with the International Monetary Fund, to the extent that any EAMS requesting financial help from the ESM are expected to also address the IMF with a similar request. This is already a sign of the limited potential of this mechanism in a situation of serious crisis.[55]

In chronological terms, the last step in the EU's fiscal policy response to the Eurozone crisis has been the approval by the European Council, on 2 March, 2012 of the so-called 'Fiscal Compact' (officially the Treaty on Stability, Coordination and Governance TSCG[56]). The contracting parties agreed to keep the budgetary position of their general government balanced or in surplus. This commitment will be considered as met if the annual structural balance of the general government is at its country-specific medium-term objective, as defined in the revised Stability and Growth Pact,[57] with a lower limit of a structural deficit of 0.5 % of the

[53] See ESM website, available at http://www.esm.europa.eu/about/index.htm As accessed on October 12, 2012.

[54] See for example BBC News, available at http://www.bbc.co.uk/news/business-19870747 as accessed on October 12, 2012.

[55] See ESM website, available at http://www.esm.europa.eu/about/index.htm As accessed on October 12, 2012.

[56] For the full text see http://www.european-council.europa.eu/media/639235/st00tscg26_en12.pdf.

[57] The Stability and Growth Pact fully entered into force on 1 January 1999 and consists of a rules-based framework with both preventive and corrective elements. It initially consisted of Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure and the Resolution of 17 June 1997 on the Stability and Growth Pact. On 20 March 2005 the Council adopted a report entitled "Improving the implementation of the Stability and Growth Pact". The report was endorsed by the European Council in its conclusions of 22 March 2005, which stated that the report updates and complements the Stability and Growth Pact, of which it is now an integral part. On 27 June 2005 the Pact was complemented by two additional Regulations 1055/05 and 1056/05, amending the Regulations 1466/97 and 1467/97. The Stability and Growth Pact is

gross domestic product at market prices. If the ratio of the general government debt to gross domestic product at market prices is significantly below 60 % and there are low risks in terms of long-term sustainability of public finances, the lower limit of the medium-term objective specified could reach a structural deficit of at most 1.0 % of the gross domestic product at market prices. In case of significant observed deviations from the medium-term objective or the adjustment path towards it, a correction mechanism shall be triggered automatically.[58]

The fiscal pact falls short of being a real fiscal constitution for the EU, not least because the decision by the UK not to sign it has made it impossible to incorporate it into the EU Treaties, although it requires contracting parties to incorporate it into their legal systems at the constitutional level. In essence, the fiscal compact is just an intergovernmental agreement.[59] Furthermore, notwithstanding the rhetoric, the fiscal pact represents little more than a replay of the Stability and Growth Pact, apart from the reference to structural budgets which, however, is considered by the experts to be more of a complication than anything else.[60] Indeed, two things clearly limit the capacity of the Fiscal Compact to be effective: first, there are no provisions for automatic sanctions, and second,

an essential part of the macroeconomic framework of the Economic and Monetary Union, which contributes to achieving macroeconomic stability in the EU and safeguarding the sustainability of public finances. A rules-based system is the best guarantee for commitments to be enforced and for all member states to be treated equally. The two nominal anchors of the Stability and Growth Pact—the 3 % of GDP reference value for the deficit ratio and the 60 % of GDP reference value for the debt ratio—and the medium-term budgetary objectives are the centrepiece of multilateral surveillance. On 16 November 2011 and 8 November 2011, Regulations 1466/97 and 1467/97 were further amended by Regulation (EU) No 1175/2011 of the European Parliament and of the Council and Council Regulation (EU) No 1177/2011 and flanked by Regulation (EU) No 1173/2011 of the European Parliament and of the Council, which endowed the Stability and Growth Pact with effective enforcement mechanisms for Euro Area member states and on 8 November 2011, the Council adopted Directive 2011/85/EU on requirements for budgetary frameworks of the member states. While not a part of the Stability and Growth Pact, this directive is instrumental to the achievement of its objectives. See http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/2012-01-24.pdf as accessed on October 20th, 2012.

[58] Full text available at http://www.european-council.europa.eu/media/639235/st00tscg26_en12.pdf, accessed October 18, 2012.

[59] De Grauwe, P., (2012), *Interview* available at :http://aregan.wordpress.com/2012/03/20/interview-with-paul-de-grauw/,accessed on October 18, 2012.

[60] De Grauwe, P., (2012), *Interview* available at :http://aregan.wordpress.com/2012/03/20/interview-with-paul-de-grauw/, accessed on October 18, 2012.

the pact allows countries to temporarily deviate from the requirements of having their budgets in balance or in surplus in case of an unusual event outside the control of the government concerned or in periods of severe economic downturn.[61]

Moreover, the pact does not include any reference to solidarity mechanisms to be activated in case of a serious crisis of one of the Euro Area member states. Although on 22 June, 2015 there was a joint declaration of the five Presidents of the EU in favour of further steps being taken in terms of integration of the Euro Area, including the establishment of a EU Treasury, these will have to be realised by 2025.[62] So there is still some time!

2.8 Conclusion

In conclusion, the burden of the costs of the crisis was inflicted on the weakest countries of the system. This was far from having been socialised among the members of the Eurozone and of the EU through the adoption of a real common fiscal policy and the attribution to the European Central Bank of its natural role as lender of last resort. It happened instead through the imposition of savage austerity plans. Indeed, the main characteristic of the EU approach to crisis management, quite apart from the rhetoric about the establishment of a new economic governance, was 'internal devaluation' with all that means in terms of pro-cyclical effects, popular resistance, political instability and eventually the threat of disruption to the EU integration process as a whole. It remains to be seen if this is a price worth paying.

[61] Full text available at http://www.european-council.europa.eu/media/639235/st00tscg26_en12.pdf, accessed October 18, 2012.

[62] See EU web-site http://europa.eu/rapid/press-release_IP-15-5240_en.htm as accessed on October 22, 2015.

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3

EMU and Structural Reform

Annette Bongardt and Francisco Torres

3.1 Introduction

These are most challenging but interesting times for Europe. As this chapter is completed (1 September 2015) Europe faces unseen challenges with a wave of refugees, most notably from Syria, who flee from a humanitarian crisis at home. This influx of refugees, which happened very shortly after the third bailout package with Greece was settled, put into perspective and somehow redimensioned Europe's (still rather comfortable by global standards) crisis notions. The images that reach us—of

Paper prepared for the JMCE and JM Chair Conference 'Europe in Crisis', King's College, London, June 2014. It also summarizes some of the topics discussed in our lectures at King's College on the Political Economy of EMU and on Structural Reforms in the EU, in 2014 and 2015. We would like to thank, without implicating, seminar participants at earlier presentations in Oxford and London, and in particular Iain Begg, Paul De Grauwe, Erik Jones, Russell Kincaid, Kalypso Nicolaïdis, Simona Talani and Roberto Tamborini, for very valuable comments and discussions.

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L.S. Talani (ed.), *Europe in Crisis*,
DOI 10.1057/978-1-137-57707-8_3

refugees with the European flag—also stand in stark contrast with the recent images of burning European flags on Syntagma Square in Athens.

Following a year wasted on the rhetoric of austerity, the European Union (EU) might now move on to address a world crisis and also at the same its structural problems. This means integrating these refugees, many of whom will become Europeans, and responding to the challenges of globalisation by putting in place the structural reforms that are necessary to deliver monetary and financial stability, higher quality growth, social inclusion and environmental sustainability, in short, making the European model sustainable. This implies completing the economic part of Economic and Monetary Union (EMU).

With EMU, the EU advanced to a higher stage of European economic integration. This higher integration stage brings about many economic benefits (outlined in the report by the Delors Committee 1989) but also substantially increases coordination needs (for Eurozone members). It led to sovereignty sharing in the monetary union part while the corresponding economic union sphere was developed later—through the Stability and Growth Pact (SGP) and the Lisbon Strategy, both of which are based on member state commitments—and became only weakly coordinated. In contrast to a monetary union, neither the concept of an economic union nor its significance with respect to the EU is well defined (Pelkmans 2006). An economic union could be a stand-alone construct, or it might be designed to meet (at least essential) requirements for the functioning of the monetary union. The EU concept of economic union as set out in the Maastricht treaty does imply some coordination of economic policies, but it was left incomplete with regard to the requirements of monetary union.

Up to the present, as stated by Bini-Smaghi (2015), Eurozone governance is characterized by a combination of centralization of competences in policy areas such as monetary policy and now banking supervision (the responsibility of the European Central Bank [ECB]) and of competition policy, state aid and external trade (the responsibility of the European Commission), with a form of "constrained" decentralization in other areas, such as fiscal and structural policies.

This chapter focuses on the issue of structural reform in the Eurozone before and after the sovereign debt crisis. The European Central Bank, to

which the conduct of monetary policy has been delegated in the EU, has consistently stressed the importance of structural reform for EMU's smooth functioning (see, for instance, ECB 2015).[1] ECB actions have been buying time but are no substitutes for member states to implement long-due structural reforms. With the sovereign debt crisis, structural reform gained urgency as to sustaining EMU. At the same time, it also became more politically charged, particularly so in countries under adjustment programmes. Politicization highlights the need for ownership of reform, but economic reform became entangled with austerity in the public debate. Yet, without economic modernization countries will not prosper in an economic environment in which competitiveness factors changed significantly, notably due to globalization, let alone be able to deal with crisis legacy costs.

The following section examines the role of economic and structural reform in EMU, starting with the Maastricht blueprint. Then we consider how soft coordination under the heading of the Lisbon Strategy fared before the crisis. Then we move on to analyse the changes that the eruption of the sovereign debt crisis in 2010 brought about, looking at the Europe 2020 Strategy, the Euro Plus Pact, and the implications of the emergence of market pressure and conditionality. We present a box information on the case of Greece, as it illustrates how a government that does not take ownership of necessary structural reforms might severely damage its own economy and compromise its future in EMU and in the EU. Next, we adopt a forward-looking perspective, shedding light on structural reform needs from the point of view of a durable crisis exit. The last section concludes.

3.2 From the Maastricht Blueprint to Economic Reform

EMU membership was made conditional on the fulfilment of entry criteria that would test whether there was a 'sufficient' prior convergence of preferences with regard to both inflation and to budgetary and fiscal discipline.

[1] See Torres (2013) for an explanation of this 'invasion of other policy domains' by the ECB: it became a guardian of EMU given that the EU's political system *per se* seemed incapable of providing timely and consistent solutions.

As had been the case with the creation of the European Monetary System before, a number of institutional questions remained open in order to allow for the establishment of a timescale for the creation of EMU. These questions primarily concerned how to enforce the convergence/stability (entry) criteria once countries had joined EMU and how to further coordinate budgetary and various other policies in order to guarantee EMU's sustainability.

The fiscal (entry) criteria were complemented in 1997 by the establishment of the SGP with regard to the post-entry period. However, institutional and economic gaps in the criteria for an optimal currency area (OCA) were not addressed. Still, developments of an endogenous character could improve matters over time (see Corsetti 2010; De Grauwe and Mongelli 2005; Eichengreen 2014; Torres 2009).

Unlike in the case of a common monetary policy, in which national central banks had been made independent as an EMU qualifying criteria,[2] there was no parallel establishment at the national level of enhanced fiscal rules or national institutional fiscal arrangements in future Eurozone member countries. As a result, the monitoring of fiscal policies and of debt accumulation was not effective: the SGP did not function satisfactorily as a fiscal disciplinary device for EMU members.[3] Furthermore, no Eurozone institutional mechanisms were put in place for a systematic detection and correction of private sector imbalances, because those imbalances would be dealt with by creditors, that is, through market discipline. In the event, creditors in some cases allowed private imbalances and debts to reach unsustainable levels.

Member states also committed to an economic reform agenda in 2000, at the Lisbon European Council. Under the heading of the Lisbon Strategy

[2] According to Masciandaro and Romelli (2015), overall the increasing trend in central bank independence is somehow reversed after 2008, namely because of central bank involvement (notably the ECB's) in banking supervision.

[3] The SGP's legalistic approach failed when the European Commission faced national arguments of 'special circumstances' (Giavazzi and Wyplosz 2015). Also, as noted by Claeys et al. (2014), in order to be effective, institutions for fiscal discipline have to be well adapted to political institutions. In the case of the EU this applies also to national political institutions, given that fiscal policy has remained a 'constrained' decentralized competence. Eijffinger et al. (2015) argue that markets had behaved in a rational manner by taking the no bailout clause as unreliable from EMU's inception. Risk weights on sovereign debts of euro members were also set at zero by the official sector.

(2000–2010), common EU objectives and benchmarks were established for member state performance, to be gauged against agreed targets. The Lisbon Strategy was, above all, driven by international competitiveness concerns and the objective to make the internal market deliver economic results (growth and employment; sustainable development) in a globalized world economy, rather than by monetary union requirements. Of course, to the extent that structural reforms and economic liberalization promote price and wage flexibility, the Lisbon economic agenda would also push the Eurozone more towards an OCA.

The Lisbon Strategy set a EU-wide reform agenda for the decade for all of its member states, whether EMU members, future EMU members or member states with a derogation to join EMU, as is the case of Denmark and the United Kingdom. While all member states recognized the need for more economic coordination at the EU level, they were—and in fact still are—unwilling to concede more competences to the European Union. As a consequence, the implementation of their commitments came to depend on soft coordination rather than being effected through the Community method.

Yet, regardless of the fact that its institutional model remained incomplete beyond monetary policy, by many accounts EMU functioned well during its first decade.[4] Given the need to allow for the establishment of a timescale to implement EMU, the Maastricht blueprint could not have been complete for a variety of reasons, notably due to the idiosyncrasy of the European construct, which had no parallel in previous experiences (Bini-Smaghi 2015). This incompleteness, however, implied institutional fragilities and allowed for the building-up of financial, fiscal and competitiveness disequilibria. On the one hand, most EU countries failed to internalize the previously agreed upon common objectives of fiscal (SGP) and of economic and social (Lisbon Strategy) governance. The lack of national reforms in some member states contributed to growing intra-EMU macroeconomic imbalances. On the other hand, economic, financial and fiscal governance institutions were unable to handle increasing policy interdependence. As a result, EMU institutions, which

[4] See Buti et al. (2010) for a collection of papers that present a comprehensive analysis of EMU's first decade.

had already been affected by the 2008–2009 global financial crisis, were incapable of dealing with the effects of the sovereign debt crisis, which started in 2010.[5]

3.3 A Soft Coordination Exercise for Economic Reform: The Lisbon Strategy

EU member states had committed to a common economic reform agenda under the heading of the Lisbon Strategy (2000–2010). It was to have produced results by the end of the decade (which incidentally coincided with the eruption of the sovereign debt crisis) and was to have left EMU more resilient to crises. The Lisbon Strategy, developed at subsequent meetings of the European Council, outlined an economic and social—and subsequently also environmental—strategy meant to relaunch the EU within the changed context of worldwide competition and the paradigm shift to a knowledge-based economy and an innovation-based model of growth (Bongardt and Torres 2012).[6] It represented a consensus on the need for a common EU-level response of EU mixed economies in terms of structural reform and institutional modernisation, to ensure the EU's and its member states' competitiveness in a world characterised by new realities and challenges, most prominently globalisation and the information society, but also demographic ageing, climate change and enlargement. The shared notion of the need for economic reform reflects the recognition that it was in each individual member state's interest to improve its economic performance and growth potential whereas the perceived need for a common, EU-wide response was rooted in addi-

[5] There were no financial backstops for stressed sovereigns or strained banks, nor for countering sudden stops in financial flows (Mongelli et al. 2015).

[6] It featured three pillars: The economic pillar was to create the basis for the transition to a competitive, dynamic knowledge-based economy, with emphasis on the need to adapt constantly to changes in the information society and to increase research and development. The social pillar was to modernize the European social model, investing in human resources and combating social exclusion. The environmental pillar, added at the Gothenburg European Council meeting in June 2001, called attention to the need to decouple economic growth from natural resource utilization for sustainable development.

tional gains stemming from positive spillovers from trade. The political economy argument was that peer pressure would help implementation across member states.

At the time of its launch, the fact that the Lisbon Strategy adopted the Open Method of Coordination (OMC) looked promising as it permitted taking into account differences in member state preferences regarding the state/market equilibrium as well as the different traditions and path-dependency of national institutions. The idea was to foster reforms tailored to both member states' heterogeneous situations and preferences. Not only does the OMC allow for consensus seeking on values and institutions but the 10-year long timeframe of the Lisbon (and successively the Europe 2020) Strategy is conducive to preference convergence within a gradual, learning process (Bongardt and Torres 2013b). It reflects a perceived need for creating ownership of reforms at the national level, through a process of slow-moving convergence of preferences on institutions (Roland 2004). However, given that instruments remained a national competence, the convergence of preferences relied on member states' willingness and capacity to put best practices and mutual learning to good use. Enforcement relied on public and peer pressure, exerted via benchmarking and ranking of each member states' performance (Bongardt and Torres 2012). Yet, by and large, public opinion in the member states failed to take ownership of reforms and exert pressure with a view to institutional modernisation, and peer pressure was largely ineffectual and official ranking abandoned. The presumption that spillovers would be positive and small can be expected to have diminished the perception of the urgency of reform.

The Lisbon Strategy's reliance on non-binding member state commitments also faced lack of ownership of reform by national governments. Member state political systems (governments, oppositions and even social partners) may have agreed to EMU-sustaining reforms in the 1990s and made commitments to them under the Lisbon Strategy during EMU's first decade but did not feel constrained to implement policies that were inconsistent with the stated objectives. Many member states largely wasted the opportunity to make use of the OMC's potential in order to find their own, most consensual path to EU-wide reform targets and create ownership of reforms. For the public, the fact that globalisation called

for economic reforms at the national level in order to transform challenges into economic opportunities often remained somewhat obscure. However, by non-compliance with modernisation targets, member states put at risk not only the functioning of EMU but also their respective national welfare states, as well as the quality of life of current and future generations.

The Lisbon Strategy goals were to create the basis for competitiveness and sustainable growth, so that member state progress on targets could be seen as an indicator of convergence to these ends. A member state scoring poorly would be less competitive and have lower growth (potential). In an analysis of member state and EU progress per policy area and overall at the end of the Lisbon decade (Tilford and Whyte 2010), what stands out are the large remaining differences in member state performance and in particular the low ranking of most of the cohesion countries, notably of Greece, Italy, Spain and, to a lesser extent, Portugal, all of which were Eurozone members. The findings suggest that those member states that failed to achieve good results on the Lisbon reform goals were the ones that started or continued to diverge.[7] Another telling finding is the EU's failure to effectively integrate the sustainability objective into the Lisbon Strategy, even more so after the Lisbon Strategy's 2005 refocus on growth and employment.[8] It is probably fair to say that the more immediate concerns with economic results somewhat eclipsed long-term sustainability concerns and their implications for future growth in the EU policy discussion (Bongardt and Torres 2013a).[9]

The combination of the absence of market pressure during EMU's first decade—financial markets failed to differentiate between the

[7] In the sovereign debt crisis, markets started to look at countries' growth potential (and thereby at individual member states' Lisbon performance) for debt sustainability reasons, penalizing through high risk premiums those that had not sufficiently progressed on economic modernization.

[8] The large differences in sustainability performance between member states indicate different levels of environmental sustainability concerns and of national policy effectiveness.

[9] This was more the case after the crisis, when many economists and politicians proposed purely Keynesian expansions, which risked perpetuating unsustainable consumption and production patterns. In our view, the need to stimulate domestic demand in surplus countries—which is not irrespective of the composition of expenditure and taxation, rather the opposite—goes hand-in-hand with the need to implement structural reforms in order to reduce built-up disequilibria in deficit countries. Structural reforms that modernize the economy are a precondition for a shift to sustainable growth.

sustainability of public debt and external imbalances among participants—and non-binding and not enforceable commitments in the case of the Lisbon Strategy and binding but not enforceable rules in the case of the SGP contributed to the procrastination of some of those (economic and institutional) reforms. The same holds true for the announced objectives (various times voted in national and European elections) to which various governments and political parties had subscribed and which were poorly implemented.

It is, therefore, hardly surprising that economic policy coordination, effected through the Lisbon Strategy and the SGP, failed to deliver during EMU's first decade. The lack of national reforms in some member states, in conjunction with the incapacity of financial markets to distinguish between Eurozone sovereigns, paved the way for increasing intra-EMU macroeconomic imbalances. Apart from its weak enforcement, the Lisbon Strategy also lacked any specific EMU dimension to address the increased interdependencies between members of a monetary union.[10]

EMU's incompleteness in the economic union part left its governance institutions unable to encompass increasing policy interdependence, let alone capable of dealing with the cumulative effects of the financial and sovereign debt crises.

The increase in economic integration to a monetary union had brought about a qualitative change, in which different member state's conceptions of the mixed economy (with its different state-market relations), when in contradiction with additional monetary union requisites on the economic side, became no longer sustainable. Albeit to different degrees, member states—especially those who were to experience severe problems later on in the sovereign debt crisis—failed (some of them dramatically) to internalise what living in a monetary union meant, let alone to internalise the challenges posed by globalisation, thereby delaying long-due reforms. Any proposed remedies—as it were, even more so under time pressure—would necessarily be more

[10] As shown by Mongelli et al. (2015), with the preparatory work for the launch of the euro in the mid-1990s (more precisely with the launch of the EMU's second phase in 1994), the nature of European integration changed, as developments in any member state could have a much greater impact on the others. The crises have been illustrative in this regard.

'intrusive' in member state affairs. After all, a country's permanence in EMU requires the compliance with those commitments made under constrained decentralisation needed to sustain it.

3.4 The Sovereign Debt Crisis: From the Europe 2020 Strategy to Market Pressure and Conditionality

In the sovereign debt crisis the large negative spillovers originating in the economic part of the union, where there had been insufficient (financial, fiscal and economic) policy coordination and domestic adjustments to prevent macroeconomic instability and imbalances, affected the monetary side.[11] They put at risk even the survival of the monetary union. With the sovereign debt crisis adding urgency to the completion of the economic union side of EMU, member states sought to address the causes of the crisis, namely banking sector fragilities, budgetary disequilibria and competitiveness differentials between member states. To curb spillovers into the monetary sphere, in particular in the Eurozone, it was most urgent to break the feedback loop between weak banks and over-indebted sovereigns.

The EU moved towards increased (albeit insufficient) coordinated financial supervision in response to the 2008–2009 global financial crisis. Under the effects from the large (and unanticipated) spillovers in the sovereign debt crisis, new mechanisms of economic governance and stronger fiscal and macroeconomic surveillance mechanisms have been established in an incremental and cumulative fashion in an attempt to sustain EMU and prepare for the increased fiscal and political integration necessary to belatedly implement a banking union and avoid financial and political fragmentation.

The sovereign debt crisis made it clear that EMU's sustainability makes additional demands on the economic union with respect to macroeconomic stabilisation, banking union and a lender of last resort (De

[11] See Torres (2015) for a detailed discussion and examples of various types of spillovers.

Grauwe 2013; Eichengreen 2014) but also to the structural domain (Draghi 2015). The latter's importance derives on the one hand from market requisites for EMU functioning (OCA criteria) and on the other from institutional modernisation being a pre-condition for promoting growth and, hence, a credible crisis exit strategy. The advances in economic governance triggered in the crisis through successive steps were prompted by the need to ensure the survival of EMU in the light of market pressure. As a result, different measures to strengthen fiscal discipline and economic coordination have come to address some of EMU's fragilities since 2010. These responses, together with the creation of the European Stability Mechanism (ESM) as a permanent rescue fund, new arrangements for financial regulation and supervision and better tools for macro-prudential supervision, arguably reduce the risk of future crises and strengthen the capacity for crisis management.[12] Yet, as far as creating an integrated economic framework is concerned, advances have remained rather limited (Mongelli et al. 2015).

It is noteworthy that, in 2010, at the time when the sovereign debt crisis began, the EU had already put on track a successor strategy for the Lisbon Strategy, denominated Europe 2020 (2011–2020), focused on the need to promote EU growth (as it were, spurred by the need for recovery from the global financial crisis, a symmetric shock to the entire EU). It was taken over by events, with little to no margin to take in lessons from the sovereign debt crisis, which was a Eurozone crisis. Its coming into existence at all testifies to the fact that the Lisbon Strategy had not delivered on its promises, because it was thought to be a one-off strategy that would expire after 10 years with the modernisation of national economies accomplished. In fact, both the aims of the Europe 2020 Strategy—promoting growth that is smart (digital), inclusive (social) and sustainable (green)—and its governance (non-binding and non-enforceable member state commitments) are rather closely modelled on the Lisbon Strategy; it also shares the same long timeframe. Like the Lisbon Strategy, Europe 2020 also lacks a reinforced Eurozone

[12] A brief summary of measures taken since 2010 to strengthen the EMU's resilience is presented in Juncker et al. (2015a). See also Mongelli et al. (2015) and the European Commission Fact Sheet on "The EU's economic governance explained" 28 November 2014, http://europa.eu/rapid/press-release_MEMO-14-2180_en.htm.

dimension. The significant innovations to be stressed are country-specific recommendations (CSR) and the European Semester process that brings together in the evaluation member states' structural and fiscal and budgetary performance (Bongardt and Torres 2013b). The Euro Plus Pact was set up in 2011 to provide a reinforced EMU dimension. However, this did not result in a tightening of governance, so that the Euro Plus Pact, too, was largely ineffective due to its weak—also intergovernmental and non-binding—method.

The various versions of the EU Presidents' Reports (Van Rompuy et al. 2012; Juncker et al. 2015a; b) seek remedy for the fact that the functioning of an economic and monetary union, as compared to a stand-alone economic union, makes additional demands notably on labour, product and financial markets with regard to flexibility and coordination requirements, which were previously unaccounted for. In light of those demands of EMU's sustainability on economic union, they advocate the need to respond to the Eurozone crisis by completing EMU's economic union part, creating a 'genuine EMU' (GEMU) with a banking union, an integrated budgetary framework, an integrated economic policy framework and enhanced democratic legitimacy and accountability of EMU governance.

So far, efforts to create such a 'genuine EMU' have only led to limited progress. As mentioned earlier, among GEMU's three economic strands it was the integrated economic policy framework that has progressed the least during the crisis (Mongelli et al. 2015), and it is still far from the level required to sustain EMU. Fiscal integration did not progress much either since 2011 but financial integration (banking union) advanced substantially. With respect to an enhanced democratic legitimacy and accountability of EMU governance, and although the institutional steps taken during the crisis appear not to be significant, a non-negligible informal, bottom-up process of political integration is occurring through the substantially increased politicisation of multilevel governance (Torres 2015).

The various Presidents' reports recognise that policy adjustment in the Eurozone cannot rely on macroeconomic policies alone. Economic integration would have to be pursued along the lines of creating

stronger incentives for structural reforms in low-productivity countries. This would help the Eurozone better meet the economic requirements for a currency union by improving the overall stability of EMU to macroeconomic shocks. However, the proposal of creating incentives for promoting structural reforms for member states, such as a system of national reform contracts to be signed with EU institutions in exchange for financial support (Van Rompuy et al. 2012), seems not to have gathered the necessary political support across member states and was abandoned.

It is against the background of an integrated economic coordination framework which barely advanced, held back by member state competences, that the Five Presidents' report (Juncker et al. 2015b) proposes building on the Euro Plus Pact, with its EMU dimension and focus on interdependencies—rather than on the EU-wide Europe 2020 Strategy. More specifically, they suggest strengthening national reform efforts through competitiveness authorities at the national level and, in a second phase, by moving to a legal base for commitments. This innovation looks like an attempt to increase ownership and the effectiveness of reforms at national levels.[13]

Still, the Europe 2020 Strategy (not mentioned in the report) is more encompassing in terms of the competitiveness notion (also environmental and social, long-term concerns) than the Euro Plus Pact, with its narrower focus on unit labour costs. The Europe 2020 Strategy thereby captures essential features for future competitiveness, namely institution-building (Gros and Roth 2012), while the Euro Plus Pact is more limited in scope and more short-term oriented in regard to competitiveness concerns. It is, therefore, important what approach to competitiveness the envisaged authorities will adopt.

Sapir and Wolff (2015) stress the need for EMU governance to address competitiveness and fiscal disequilibria and thereby 'to move beyond the improvements brought about by banking union'. They propose the establishment of a European Competitiveness Council composed of national

[13] The proposal of such a legal base in the second phase suggests that the five presidents have little faith in the delivery of national structural reform through non-binding coordination (Begg et al. 2015).

competitiveness councils and the creation of a Euro System of Fiscal Policy to oversee fiscal debt sustainability and an adequate area-wide fiscal position.[14]

The above discussion shows that—beyond completing a banking union—in the present EU governance set-up any attempts at moving the Euro Area closer to an OCA, or to at least transform it into a Sustainable Currency Area,[15] require reforms in areas where competencies have remained at the member state level. For the time being, this is only possible through structural reform and adjustment capacity within the member states.

That notwithstanding, the sovereign debt crisis has been a game changer for softly coordinated economic reforms. This is because market pressure surfaced as an additional source of pressure for increasing lagging member states' reform efforts and also because conditionality made an appearance through the access to funds for those countries that were cut off from capital markets for their financing needs. The new crisis-enacted mechanisms and the conditionality-linked availability of funds have clearly started to positively affect the implementation of structural reforms. In fact, there has been an acceleration of structural reforms in laggard countries—including Greece, at least until 2014—as a result of market and peer pressure and of formal and informal conditionality (Schmieding and Schulz 2014; OECD 2015). The relevance of those reforms rises in a context where fiscal policy is also constrained due to the need for an enduring correction of the budgetary imbalance (Bini Smaghi 2015). Without member states' efforts to create ownership of reforms, there may, however, be a political backlash.

[14] The link between fiscal policy and structural reforms is not irrelevant as the former is constrained by the need to ensure a proper adjustment of the budgetary imbalance and the latter can increase the credibility of the adjustment programme and thereby achieve a more gradual fiscal adjustment (Bini-Smaghi 2015).

[15] On the concept of sustainable rather than optimum currency areas, see Torres (2009). It is more or less agreed today that the one fundamental ingredient for a sustainable monetary union is banking union (Philippon 2015).

BOX

A National Government That Does Not Take Ownership of Economic Reform: The Case of Greece

It was the outbreak of the crisis in Greece in 2010 that triggered the sovereign debt crisis. Greece has become the (only) showcase of a Eurozone country under an adjustment programme, where a government decided unilaterally to abandon structural reform efforts. The case of the Syriza government in Greece has shown that if a Eurozone member state is not prepared to comply with commitments to modernise its economy, EMU's sustainability could be at risk in the present incomplete governance set-up. The Syriza party came to power reneging on the agreements made by its predecessors in exchange for two bailout programmes and substantial debt forgiveness. In the event, the other Eurozone members found ways around the non-bailout clause, going ahead with a third bailout programme and, according to Buiter (2015), with soft bailouts of the Greek banks and the government under the guise of liquidity assistance. They kept Greece afloat.

Previously, adjustment programme countries had received solidarity in exchange for structural reform. One may doubt whether solidarity, if unilateral and repeated as in the case of Greece, would find the favour with Eurozone taxpayers of the other member states over the longer term. On the one hand, agreed reforms were either not implemented, or not implemented on a sufficient scale (Blanchard (2015). On the other hand, as put by Giavazzi (2015): 'Since Athens joined the monetary union, we have lent Greece €400bn, 1.7 times the country's gross domestic product in 2013. (…) they will never be repaid' or, as stressed by Blanchard (2015), only 'the 2012 private sector involvement operation led to a haircut of more than 50% on about €200 billion of privately held debt, so leading to a decrease in debt of over €100 billion (to be concrete, a reduction of debt of 10,000 euros per Greek citizen)'. Also, interest payments by Greece (which features by far the highest debt to GDP ratio in the Eurozone) are significantly lower, as a proportion of GDP, than interest payments by Portugal, Ireland, or Italy (De Grauwe 2015) or even lower than Spain's and Belgium's, according to Darvas (2015).

The 2015 negotiations with the Syriza government proved a waste of time with very high costs for Greece and for the rest of the Eurozone, especially for its poorer member states. The Syriza government's negotiation strategy seemed to be based on betting on generating contagion fears in the Eurozone (Feld et al. 2015), namely to Cyprus, Ireland, Portugal, Spain and Italy, in order to get additional aid to later unilaterally default on its EU official creditors (Eurozone taxpayers) on as high an amount as possible and get rid of any reform obligations; other threats ranged from 'inundating' other Eurozone members with illegal migrants

to establishing a special relationship with Russia. Such behaviour not only damaged Greece's European credentials, but also brought its recovery from the crisis to a halt (Blanchard 2015; Phelps 2015). It also delayed the progress in consolidating EMU as well as the recovery in other member states.

The only reason that the Syriza government's strategy suffered a complete turnaround (apart from the fact that non-Eurozone countries might have been sympathetic in words but did not open their purse), whereby it accepted another (the third) bailout programme for Greece after a 'no' referendum on the previous offer, which had already expired—in itself a very poor exercise in terms of democracy—was that it understood that even defaulting on most of its debt and resorting to its own currency it would be unable to deliver anything acceptable to its citizens.

Still, there was strong support by the international press but also by some EU governments and institutions, notably the French government and at least part of the European Commission, for the view that Syriza had been elected and therefore it would be undemocratic for the creditors to impose their conditions, even less through an 'undemocratic troika'. However, as expressed by Dixon (2015), 'democracy in one country does not mean that other countries have to lend it money with no strings attached'. Some of those countries are much poorer than Greece.

Syriza's stance was also partly accommodated, if not encouraged, by the fact that the debate on the crisis has centred on austerity and too little attention has been paid to the longer-run determinants of growth and its quality (sustainable growth) or the appropriateness of EU approaches. That stance has been supported by what Scally (2015) calls 'the English-language world view of Greece, coloured by the Keynesian economic tradition', with a strong influence on world public opinion.

However, as argued by Phelps (2015), 'spending more is not the remedy for Greece's plight just as spending less was not the cause. (…) The remedy must lie in adopting the right structural reforms'. As shown by Blanchard (2015), output decline in Greece cannot be ascribed to austerity (fiscal consolidation) but it was mainly caused by output above potential to start with, in conjunction with political crises, inconsistent policies, insufficient reforms, Grexit fears, low business confidence and weak banks. For Philippon (2015) 'Greece was (mostly) brought down by reckless government spending during the boom years' and by a disastrous government in the first half of 2015. In fact, as stressed by the German Council of Economic Experts (GCEE 2015), the economic turnarounds in Ireland, Portugal, Spain and—until the end of 2014—also in Greece show that loans conditional on reforms can work.

In conclusion, the lack of ownership of economic reform by the national government has proven disastrous for the country and it carries a high cost

for the other members of the Union. Greece, or any other EU member state, therefore has the choice of addressing structural reforms in order to move on to sustainable growth (and, therefore, to a fairer model of society) or being prepared to continuously deteriorate living standards and internal social cohesion and quality of life vis-à-vis their partners. As shown by Gros (2015) for the case of Puerto Rico, even a 'genuine' economic and monetary union like the USA cannot prevent regional failures of this kind. The only difference is that in the case of Puerto Rico there seems to be little criticism of the US dollar for the failure and of the US government for lack of solidarity (Puerto Rico is left to the mercy of the markets).

Apart from EMU resilience, structural reforms are also important for higher potential growth (Draghi 2015) and hence for dealing with legacy costs and with exit from the crisis. Nevertheless, whereas appropriate structural reforms are growth enhancing in the long run, they often fail to bring about immediate benefits (IMF 2015) while causing frictions at a high political cost when they collide with entrenched interest groups or affect vulnerable social groups. The common objectives put down in the Europe 2020 Strategy have, with the sovereign debt crisis, come to encompass increasingly salient political and distributional issues, not only in but also between member states. The enforcement, under market and peer pressure and conditionality, of objectives to which the member states already committed risks being perceived as intrusive as competencies have remained national. This is especially complicated when conditionality in adjustment countries coincides with EU institution building (Nicolaïdis and Watson 2016).

The case of Greece shows that, without increased sovereignty sharing, the new governance framework still remains vulnerable to adverse market and political-economy pressures. So far Cyprus, Ireland, Portugal and Spain seem not to have succumbed to the Greek disaster, although the jury is still out for these countries as well as for other member states, notably Italy and France. Therefore, even if macroeconomic stability was to substantially improve, the as yet incomplete recasting of the governance of EMU leaves it at risk without structural reforms.

One might ask what the implications would be if a member state opted for not honouring its 'constrained' commitments to sufficiently

reform and modernise its economy and society to be part of a dynamic economic and monetary union. That member state should assume the responsibility for its choice of following a different economic model but do so without putting at risk the Eurozone's common good of monetary and financial stability and of other Eurozone members' budgetary sustainability. That would suggest leaving the Eurozone, but Euro exit is not foreseen in the Treaties, which allow for voluntary exit from the EU but not for Euro exit alone. The question then becomes whether there is any alternative to make EMU function regardless of lacking member state progress on economic reform. It is possible but requires a monetary union that is no obstacle to an orderly restructuring of the sovereign debt of one of its members (see Philippon 2015 for a more complete proposal). This amounts to a credible non-bailout regime. There is also the possibility of a drastic form of banking union *à la* Buiter (2015), which makes it possible to rescue the banks without rescuing the sovereign. In those cases, member states would be free to choose whether or not to comply with reform commitments, given that they alone would suffer the dire consequences (lower living standards and, most likely, a more unfair type of society) of their political choices (Giavazzi 2015; Phelps 2015).[16]

3.5 Structural Reforms and a Durable Exit from the Crisis

When we are concerned with long-term sustainability, a sustainable growth strategy with structural reforms at the national level is a precondition for a credible exit strategy and a durable recovery. According to the ECB (2015) the smooth functioning of EMU warrants growth that is sustainable in the long run, which implies that any economic recovery

[16] The above-mentioned case of Puerto Rico in the USA bears many similarities with the case of Greece. Both delayed overdue reforms and arrived at the brink of bankruptcy. However, Puerto Rico, a member of a financially integrated monetary union, did not put the monetary union at risk. It did not receive any help from the USA either, and entered into default (see Gros 2015). In the case of Greece, Eurozone partners paid the country's debts to the IMF (which were overdue) and to the ECB.

from the crisis needs to be durable. Sustainable (not only economically but also environmentally) growth thereby offers both a crisis exit strategy and adds to the wider benefits from EU integration. As we suggested elsewhere (Begg et al. 2015), EMU can be sustained both in the more immediate crisis context and in the long run as part of a political sustainable integration project, which envisages high-quality growth and respects longer-term budgetary challenges.

Even on purely economic grounds, economic growth will not be sustainable—and any recovery not durable—unless environmental damages and resource depletion and long-term, intergenerational effects are internalised[17]; nor would it be politically sustainable.[18] Sustainable growth requires that the use of natural resources be efficient, pollution and environmental impacts be minimised, and the resilience to natural hazards be raised (Hallegatte et al. 2011). Any general call for growth ('whatever kind of growth'), and one which makes do with sustained rather than sustainable growth, ignores the economic case for environmental protection and with it environmental constraints on growth, let alone the EU's commitment to a model of development with quality, sustainable growth[19] and a moral obligation (towards the less well off and future generations) of dealing with climate change.[20]

The need for long-term sustainable growth for EMU sustainability first of all begs the question whether it is possible to promote sustainable growth within the crisis context given a one-fits-all monetary policy and budgetary constraints. As for monetary policy, it can smooth out cyclical shocks but it is unable to solve structural problems. ECB actions (just like a more expansionary fiscal policy stance in the Eurozone) can only buy

[17] Climate change is a case in point of environmental constraints to economic growth (UNEP 2014). For the economic case for combatting climate change, and for decarbonisation, and positive growth effects in the short and long run, see for instance Fay et al. (2015), Nordhaus (2006), Spence (2014) and Stern (2006, 2015).

[18] Environmental protection and combatting climate change reflect European citizens' values and priorities, as Eurobarometer surveys have consistently indicated.

[19] Sustainable development has been an objective of the EU for about three decades (the concept goes back to the so-called Brundtland report, World Commission on Environment and Development 1987). The 2009 Lisbon Treaty goes further, committing the EU to a high level of protection and improvement of the quality of the environment in the management of the single market (Art.3 (3) TEU).

[20] See for instance the encyclical letter on the environment by Pope Francis (2015).

time for member states to address their structural problems; they cannot solve them. Structural reforms are, therefore, a precondition for generating sustainable growth and for putting countries on a higher potential growth trajectory (ECB 2015). As for budgetary constraints, one should note that a fiscal stimulus (even if feasible) is a crude instrument. As such it is unlikely to result in quality growth *per se*, unless it deals with the causes of competitiveness problems. Incentives for growth can be provided not only through the level but also, and perhaps more importantly, the composition of expenditure and incentives on the revenue side, notably taxation (Giavazzi and Wyplosz 2015; Begg et al. 2015).

The implementation of the sustainable growth objective requires two things: a clear long-term agenda and policies and instruments that are consistent with those long-term objectives. The latter need to provide the right incentives for green innovation and pollution abatement while minimising possible short-term trade-offs between environmental protection and growth. The governance of sustainable growth in relevant areas in the EU is piecemeal and methods and enforcement possibilities vary significantly. Although diverse governance methods are not a problem in itself as long as the different approaches are in synergy, the EU still lacks a coherent strategy for sustainable growth, a holistic approach to direct instruments used towards the common good and a consistent evaluation of measures with respect to final goals (European Commission 2010; EEA 2015). That notwithstanding, performance is encouraging if one considers that the environment sector has managed to create employment ever since the outbreak of the global financial crisis in 2009, even though the soft coordination approach towards sustainable growth has so far failed to realise the full innovation, competitiveness and growth potential that it promises (EEA 2015).

Progress towards sustainable growth is intricately linked with the EU's long-term structural reform agenda, now pursued under the Europe 2020 Strategy. The EU employs soft coordination processes in its quest to reconcile sustainable growth objectives, competitiveness, employment, and a more inclusive society in Europe.[21] Sustainable growth hinges on

[21] Starting with the Lisbon (2000–2010) and Sustainable Development Strategies (2001, revised in 2006), which came together in the Europe 2020 (2011–2020) Strategy.

decision making for the long term, ultimately shaped by the implicit discount rate applied by society (see for instance Dasgupta 2007), and an economy capable of flexible adjustment with an innovation-friendly business environment. The reason is that it involves both structural change within the economy and in society and a long-term oriented governance system (Pearce and Turner 1990: 24; Randers 2012). Structural reforms that raise the innovation potential and foster a flexible adjustment capacity are key for competitiveness and crisis exit (for a discussion of the case for crisis-stricken Greece see Blanchard 2015; Phelps 2015), hereby including an adequate business environment. The Europe 2020 Strategy provides such an economic modernisation agenda and it is also geared specifically towards sustainable (green) growth.

However, the sustainable development objective was not well integrated in the Lisbon Strategy after the Strategy's mid-term refocus on growth and employment (Tilford and Whyte 2010) and remained relatively unconnected with the smart and inclusive growth dimensions in the Europe 2020 Strategy (Pasimeni 2011). It is also fraught with a Europe 2020 headline target on greenhouse gas emissions that became insufficiently ambitious to promote green innovation and investment, as the sovereign debt crisis led to lower emissions along with depressed economic activity. A more systematic look at the issue of the transmission mechanism between the completion of the single market and Europe 2020 Strategy (and their respective methods, the Community method and the OMC) is also warranted (European Commission 2010) due to their overlap and the insufficient transmission so far in the area of sustainable growth (Bongardt 2015). Progress may be held back by member state competencies, notably in the area of regulation (Schaeffer and Baumann 2011). or by the failure to force markets to internalise externalities, or by any other combination of factors.

The overall European objective of transforming its economy into a low-carbon green economy produces important economic benefits in the long run, but rather obviously the cost-benefit balance depends on how well it is implemented in the shorter term (Bongardt and Torres 2013b). Apart from the adequacy of policies and instruments, it will also be much conditioned by the characteristics of the EU Energy Union that is being created (Egenhofer et al. 2014). In the crisis context, public opinion in

Europe has been concerned first and foremost with dealing with the effects of the immediate economic crisis, although longer-term environmental concerns have for a long time consistently been among European citizens' priorities.[22] It is important to communicate that such a dichotomy is unfounded because addressing both can be mutually reinforcing with regard to the economic and political resilience of the European project.

With regard to the political sustainability of structural reforms, sequencing ought to be a relevant concern: those reforms that are growth enhancing in the short run should be prioritised, and private investment encouraged in ways compatible with fiscal constraints. As for sustainable growth, appropriate taxation and tighter regulation to promote green investments are a case in point (Pisani-Ferry 2014). The use of fiscal instruments opens up the perspective of promoting sustainable growth by shifting taxation onto inefficiencies (like pollution), away from taxing productive factors (such as labour). Taxes carry a double dividend, in that they provide receipts for the state and discourage inefficient behaviour.[23] The abolition of incentive-distorting inefficient subsidies (negative taxes), like the ones on coal (IEA 2014), likewise reduces government expenditure and improves the state of the environment by lowering carbon emissions. Economic instruments (like taxes and transferable emission licences) have dynamic efficiency properties, promoting innovation, and provide least cost abatement of pollution; as such they are very much in tune with the Europe 2020 goals of (green) growth. In addition, regulation (market rules) can be used to foster private green investments without incurring fiscal expenditure. Demanding EU harmonised environmental regulation can provide a push for EU green innovation and cost-efficiency.[24] For that it needs to be perceived as part of a sustainable growth strategy rather than as constituting red tape. The circular

[22] Eurobarometer (http://ec.europa.eu/public_opinion/archives/eb/eb82/eb82_first_en.pdf).

[23] EU level fiscal instruments require unanimity in the Council of the EU. While member states can impose taxes or cut subsidies at the national level they will be reluctant to do so if that implies competitiveness disadvantages in the internal market.

[24] EU environmental regulation provides for minimum standards with a view to avoiding a race to the bottom in member state regulation standards. Conversely, demanding EU harmonized environmental regulation can be used as an instrument to foster EU green innovation and cost-efficiency.

economy package[25] is a case in point where demanding EU regulation can promote growth and employment creation (European Environment Agency 2015). Its fate will be indicative of the EU's resolve in implementing sustainable growth. The same can be said for the Commission's new European Fund for Strategic Investment (EFSI), where much will depend on whether it will be oriented towards long-term sustainable growth.

3.6 Conclusion

Monetary policy can smooth out cyclical shocks but it is unable to solve structural problems. Therefore, ECB actions, just like a more expansionary fiscal policy stance in the Eurozone, can only buy time for member states to address their structural problems; they cannot solve them. Structural reforms are, hence, a precondition for generating sustainable growth and for putting countries on a higher potential growth trajectory.

Thus far the process of creation of new institutions and mechanisms displayed significant political and institutional resilience to the crisis. However, progress has been particularly scant with regard to creating an integrated economic framework within a 'genuine EMU'. Arguably, governments and citizens were not mobilised around a new impetus for European integration in the midst of the crisis, which in turn raises the question of the longer-term political sustainability of both EMU and the European Union project (see Jones and Torres 2015).

There is a need for structural reform on economic grounds, for EMU resilience and long-term sustainable growth, but also, for political sustainability reasons, calling for ownership of reforms. With the crisis, formerly vague references to European restrictions in national political debates have become more explicit constraints that are better understood by citizens. Thereby the opacity of domestic political and policy processes

[25] The circular economy package was aimed at making the European economy more resource-efficient by increasing recycling levels and tightening the rules on incineration and landfill. Drawn up by the Barroso Commission, it was withdrawn by the incoming Juncker Commission in December 2014 amidst wide-ranging protests, among which were EU environment ministers, Members of the European Parliament (MEPs), and Non-Governmental Organizations (NGOs). The Commission announced that it would table an improved package in 2015, more ambitious and aimed at cutting red tape. At the time of writing (August 2015) its fate was still unknown.

has been reduced, potentially raising policy effectiveness. Debates on structural reform and long-term development objectives in the EU multi-level political negotiation process would help increase ownership of structural reforms and new institutions by the public. Hopefully, they will also increase the acceptance of economic reforms against the background of wider benefits from EU integration.

The step towards centralisation of competences in the economic reform domain has been resisted in the past by member states and it is uncertain whether this will change any time in the future. The prior discussion has shown that what is needed is (creating) national adjustment capacity and willingness to implement economic reforms without which EMU (or at least the membership of that respective country in EMU) will not be sustainable.

Should it not be possible to create sufficient national adjustment capacity, EMU resilience can still be guaranteed by putting in place a functioning banking union with an orderly state bankruptcy regime. The EU would thereby move towards US practice. However, in that case it would be those member states that did not comply with reform commitments that would bear the consequences alone (lower living standards and, most likely, a more unfair type of society) of their political choices.

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4

Wage Imbalances in the European Labour Market

Stefan Collignon

A prominent explanation for the Euro crisis is that lack of competitiveness in Europe's south has caused macroeconomic imbalances and unsustainable debt in the private and public sector. This argument implies that a monetary union functions like a fixed exchange rate arrangement, only the mechanism for keeping the exchange rates fixed is stronger. This logic requires that debtor countries need export surpluses to service their debt. I have shown that this claim is fundamentally flawed (Collignon (2014). Taking European integration seriously: competitiveness, imbalances and economic stability in the Euro Area. In S. C. Esposito, *Competitiveness in the European economy. Routlege, London.* London: Routledge). A currency area functions like a domestic economy, which means that contrary to debt in foreign currency, domestic debt can be serviced out of profits in the non-tradable sector and not only by export earnings. What is needed

Scuola superior Sant'Anna and London School of Economics. I thank Piero Esposito and Marco Forti for research assistance.

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L.S. Talani (ed.), *Europe in Crisis*,
DOI 10.1057/978-1-137-57707-8_4

is balanced growth between the sectors and between regions (countries). In this context, competitiveness takes a new role—not as a measure of comparative advantage in foreign trade, but as a measure of profitability for investment. In this chapter I shall present a new index for measuring the competitiveness of wage levels based on the return on capital in the Euro Area.

4.1 Measuring Competitiveness

There are many approaches for measuring competitiveness. Some focus on a broad range of variables evaluating conditions for doing business,[1] others on relative cost advantages.[2] The optimum currency area literature has established that labour market flexibility is a necessary condition for the sustainability of a single currency in heterogeneous economies because the exchange rate is no longer an adjustment tool. Given that flexibility in terms of labour movements across borders is relatively low in the Euro Area, wage flexibility must be the key variable for correcting potential imbalances. However, this raises questions about what is the appropriate wage level in an integrated economy.

A frequently used measure of wage cost competitiveness is the index for unit labour costs (ULC),[3] defined as the cost of total wage compensation per unit of output, where output is defined as GDP at constant prices. However, an index only shows the *cumulative changes*; it says nothing about the *level* of relative costs and whether they reflect an equilibrium or disequilibrium in the arbitrarily chosen base year. In order to circumvent the arbitrary base year problem, some economists have divided the ULC index by a long run average of 40 decades.[4] While this approach dampens

[1] Most prominent are the Global Competitiveness Report published by the World Economic Forum (http://www.weforum.org/reports/global-competitiveness-report-2013-2014) and the IMD World Competitivness Year Book (http://www.imd.org/wcc/).

[2] The usual measures are indices for real exchange rates, based on relative prices of commodities and export baskets converted by given exchange rates. See: Eurostat (http://ec.europa.eu/eurostat/en/web/products-datasets/-/TSDEC330), OECD (http://stats.oecd.org/Index.aspx?querytype=view&queryname=168), IMF https://www.imf.org/external/pubs/ft/fandd/2007/09/pdf/basics.pdf).

[3] See (Sinn 2013); (Flassbeck and Spiecker 2010).

[4] See for example: (Wyplosz 2013) and my comment on the following pages.

the distortions, it remains an ad hoc and a theoretical assumption. The proper approach would use an index that shows the *absolute levels* of relative wage cost competitiveness.

In earlier work, I have developed such an index for unit labour costs, where the equilibrium is derived from assuming perfectly competitive market equilibrium so that the return on capital is identical in all member states and labour costs reflect this equilibrium.[5] Of course, this is only a theoretical benchmark and not a description of facts, but it allows for the measurement of the handicap in attracting investment to particular countries. Within the free European internal market, capital ought to be invested where it yields the highest return, while diminishing returns will erase these excess returns over time. The competitiveness is then measured by the ratio of actual to equilibrium labour costs.

This index has the advantage of measuring real distortions in the European labour market. It advances the literature insofar as it establishes equilibrium levels from sound theoretical foundations. However, the calculation of nominal equilibrium ULC is still dependent on the price index, so that with the shift of the GDP deflator base year from 2000 to 2005 and 2010 we get inconsistencies in time series. In addition, practical difficulties for comparing unit labour cost time series have arisen from the new system of European Statistical Accounts (ESA 2010 system), which has changed the way GDP is calculated. Nevertheless, these difficulties can be circumvented by reformulating the equilibrium concept for the *nominal wage level* and not for *nominal unit labour cost*.

4.2 Defining Equilibrium Wage Levels

We define nominal equilibrium wages as the total labour compensation level, at which the average return on the capital stock in a given economy is equal to the average return in the Euro Area as a whole. The return on capital is the ratio of non-wage value added relative to the historic value of the aggregate capital stock of a country or sector. Hence, it can be

[5] See (Collignon, Macroeconomic imbalances and competitiveness in the Euro Area, 2013); (Collignon, Stefan and Piero Esposito 2014).

described as the product of the capital share (which is the complement to the wage share σ_w) and the average efficiency of capital (ACE). The average capital efficiency is measured in nominal terms, which means it is determined by the ratio of the GDP-deflator P to the price deflator for capital goods P_k and physical capital productivity, in other words, output to capital at constant prices:

$$\text{RoC} = \frac{Py - wL}{Py}\frac{Py}{P_k K} = (1 - \sigma_w)\text{ACE} \tag{4.1}$$

where Py is GDP at current prices and P_kK is the value of the accumulated capital stock at historic cost; w stands for the labour remuneration per worker (the 'wage') and L is the number of people employed. Clearly, the return on capital rises when the efficiency of the capital stock improves. The inverse of ACE is the nominal capital-output ratio (COR).

$$\text{ACE} = \frac{Py}{P_k K} = \frac{1}{\text{COR}} \tag{4.1a}$$

We also define labour productivity as nominal output per person employed:

$$\lambda = \frac{Py}{L} \tag{4.1b}$$

We can then set the equilibrium condition as:

$$\text{Roc}_x = \text{Roc}_{\bullet} \tag{4.2}$$

$$(1 - \sigma_{wx})\text{ACE}_x = (1 - \sigma_{w\bullet})\text{ACE}_{\bullet} \tag{4.3}$$

where Roc_x is Return on capital in country x, calculated as the non-wage share of GDP relative to the nominal value of the aggregate capital stock (ACE) and σ_{wx} is the wage share of country x. We also note

that by definition the capital share is the complement of the wage share: $\left(1-\sigma_{w\bullet}\right)=\sigma_{k\bullet}$

The equilibrium wage share is then:

$$\sigma_{wx}\cdot=1-\left(1-\sigma_{w\bullet}\right)\frac{\text{ACE}_{\bullet}}{\text{ACE}_{x}}=1-\sigma_{k\bullet}\frac{\text{ACE}_{\bullet}}{\text{ACE}_{x}} \tag{4.4}$$

Equation (4.4) also represents a country's equilibrium real unit labour costs because the wage share is an identical expression of real unit labour costs.[6] Thus, if a country's capital efficiency improves relative to the Euro Area, in other words, if $\text{ACE}_{€}/\text{ACE}_{x}$ falls, then its equilibrium wage will rise. If a country's capital productivity exceeds average European capital productivity, so that $\text{ACE}_{\bullet}/\text{ACE}_{x}<1$, the equilibrium wage share (and therefore its real unit labour costs) will be below the Euro Area level. Because of (4.1a) this amounts to saying that the national capital-output ratio is lower than the Euro Area's, and in equilibrium the share of value added that goes to remunerate capital is higher because capital is more productive.

Because the nominal wage *w* is identical with the product of nominal labour productivity $\lambda=Py/L$ and the wage share $\sigma_{w}=wL/Py$, the country-specific nominal equilibrium wage is:

Equilibrium wage = labour productivity $\lambda\times$ Equilibrium wage share $\left(\sigma^{\uparrow}*\right)$:

$$w^{\cdot}=\lambda\sigma_{wx}\cdot=\lambda-\lambda\left(1-\sigma_{w\bullet}\right)\frac{\text{ACE}_{\bullet}}{\text{ACE}_{x}}=\lambda\left(1-\sigma_{k\bullet}\frac{\text{ACE}_{\bullet}}{\text{ACE}_{x}}\right) \tag{4.5}$$

It is clear that the equilibrium wage so defined is a function of the average wage share (or its complement the capital share) in the Euro Area, national labour productivity and the relative development of nominal capital efficiency, in other words, relative prices of goods and capital and the national capital productivity (y/K) relative to the Euro Area's. If a country's

[6] Unit labour costs are defined as the wage costs per unit of output: $\text{ULC}=wL/y$. Hence real unit labour costs are $\text{RULC}=\text{ULC}/P=wL/Py=\sigma_{w}$.

capital efficiency is equal to that of the Euro Area, the equilibrium wage is the same as the average European wage, but different endowments of capital and capital productivity will require different wage shares. We assume the Euro Area wage share is exogenously given as our benchmark, although it is not constant.

To measure competitiveness, we match the actual labour compensation against this equilibrium wage. If actual wages are higher than the equilibrium wage, the return on capital in a particular country or industry will be lower than the Euro-average. We interpret this as a competitive disadvantage, for lower profitability is likely to deter investment until the return on capital is improved, while highly competitive sectors and countries would attract capital and boost economic growth until over-accumulation reduces the return. Hence, wage cost competitiveness depends on actual wages as they emerge from wage negotiations and on structural factors that shift the equilibrium wage. It also depends on the average wage share of the Euro Area, in other words, on how aggregate wages develop relative to inflation and productivity in the Euro Area as a whole. If a particular region deviates from the average performance, it will gain or lose competitiveness. This means that if wage increases in the Euro Area slow down as a whole, all countries would have to follow suit if they wish to remain competitive. However, because European wage bargaining is highly decentralised and national, economic policies for improving competitiveness must focus on the structural factors that determine the equilibrium wage, namely relative price developments and productivity.

Our concept of equilibrium wage is important as it defines the limits for wage increases that are consistent with stimulating demand in pursuit of a wage-led growth strategy. Observing that a reduction in the wage share has been correlated with low growth, some economists have suggested a strategy of wage-led growth to overcome austerity in Europe.[7] Yet, if higher wages damage competitiveness, wage-led growth strategies would be counterproductive. The famous *Rehn-Meidner rule* recommended that nominal wages ought to increase at the rate of productivity plus inflation, so that the wage share remains constant. In the Euro Area that has been

[7] (Stockhammer 2015), (O. Onaran and Th. Obst 2015).

amended to say that wage increases should take into account labour productivity and the inflation target of the European Central Bank (ECB).[8] However, this rule ignores the impact of capital productivity on equilibrium wages. Balanced growth would require that nominal wages be equal to equilibrium wages and then vary with changes in national equilibrium wages. As Eq. 4.5 shows, the effect of capital productivity on equilibrium wages is far from trivial. Even if all countries had exactly the same rate of nominal wage increases in line with the *Rehn-Meidner rule*, their competitiveness could still be distorted by diverging productivity developments. Such divergence may be a consequence of broad country-specific factors, such as infrastructure, R&D, skill building, etc., but it may also reflect different weights of economic sectors with diverse capital-output ratios. For example, it is well-known that productivity is more likely to improve in manufacturing than in most service industries, so that an industrial hub like Germany is prone to reap larger competitive advantages than service intensive economies.

The equilibrium wage will increase not only when labour productivity (GDP per worker) rises, but also when the capital-output ratio in a given country rises faster than in the Euro Area as a whole. At the first look, this seems paradoxical, for it implies that the average efficiency of the national capital stock (ACE) is lagging behind the Euro Area average. However, we have seen above that this means that less productive capital is getting less remuneration and therefore labour can get more. But this raises the question how capital accumulation affects labour productivity. It is a well-established fact from neoclassical growth theory that average and marginal labour productivity will increase when the capital/labour ratio (i.e., the capital intensity of production) increases (Solow 1956). It follows from Eqs. (4.1a) and (4.1b) that labour productivity is the product of ACE and the capital-labour ratio (also called the capital intensity of production). In this chapter, I assume that the capital-labour ratio is exogenously determined by technology (at least in the short run) and relative factor prices, and we concentrate on capital productivity as the crucial variable determining wage competitiveness.

[8] See (Koll 2005); (Commission 2005).

Referring back to (4.1a), taking logs (written in small caps) and differences, we get the rate of change for $ACE_{€}/ACE_{x}$ as:

$$d\ln\left(\frac{ACE_{\bullet}}{ACEx}\right) = d\ln\left(\frac{COR_{x}}{COR_{\bullet}}\right)$$
$$= d\left[\left(p_{k} - p_{k\bullet}\right) - d\left(p - p_{\bullet}\right)\right] - d\left[\left[\left(y - k\right) + \left(y_{\bullet} - k\right]_{\bullet}\right)\right] \quad (4.6)$$

which is the capital efficiency effect on the equilibrium wage:

ACE effect = (relative capital equipment inflation – relative GDP inflation) – relative change in the physical capital productivity.

Because of Eq. (4.5), the equilibrium wage in a given country will increase when the average capital efficiency-effect exceeds the Euro average and the ACE-effect is negative. Thus, ceteris paribus, it will rise when a county's GDP-inflation is higher than in the Euro Area, but not if prices for capital equipment rise faster. The equilibrium wage will also rise when capital productivity at constant prices is increasing faster than in the Euro Area. However, it should be noted that in a competitive market prices cannot deviate from the average for too long. Sooner or later they will adjust and the temporary gain of higher equilibrium wages and competitiveness will be lost. In the long run it is capital productivity that drives the equilibrium wage dynamics.

4.3 Empirical Estimates

We will now look at the estimates of equilibrium wages in the Euro Area.[9] Figure 4.1 shows the time series for equilibrium and actual wages. We will say that a country is overvalued if its actual wage exceeds the equilibrium wage and it is undervalued in the opposite case.

The most striking feature is that all new member states are undervalued, regardless of whether they are inside or outside the Euro Area. Within the Euro Area, five countries, amounting to more than 53 % of Euro Area

[9] The data are obtained from the European Commission's Ameco data base.

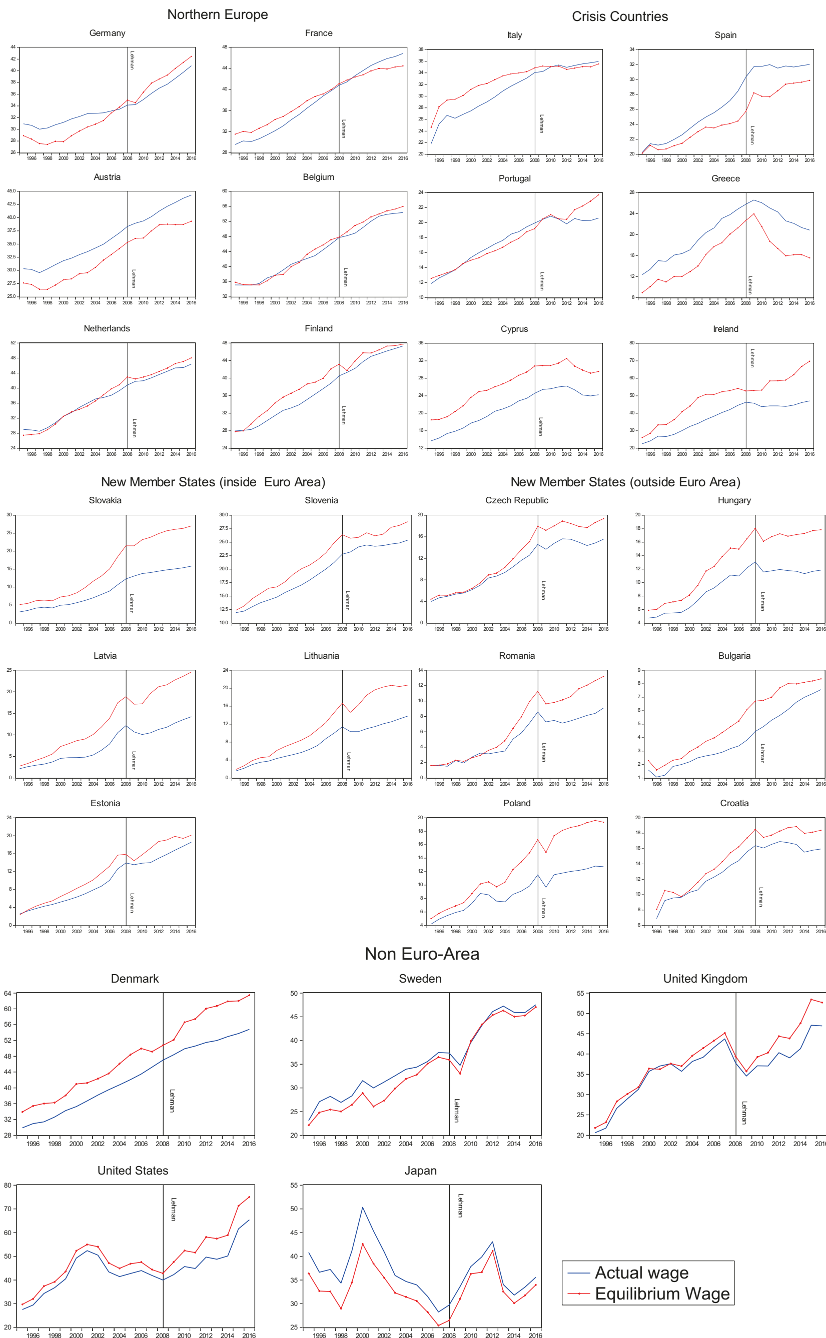


Fig. 4.1 Times series for equilibrium and actual wages

GDP, are above equilibrium wage levels: Greece, Austria, Spain, Italy and France. Among the six northern Euro Area members, two (Austria and France) are overvalued, while among the southern crisis countries this is true for three member states (Italy, Spain, and Greece). Among western industrialized countries outside the Euro Area, Denmark, the UK and the USA are undervalued, but Sweden and Japan are overvalued.[10] Actual wage developments are steadier than equilibrium wages which depend on productivity and are therefore subject to shocks and cyclical influences. However, there seems to be a structural break in nominal wage increases since the Euro crisis in all member states except in the northern Euro Area. In Greece, competitiveness has significantly deteriorated during the crisis despite massive cuts in nominal wage levels, because austerity policies have negatively affected productivity and therefore the equilibrium wage.

Table 4.1 shows actual and equilibrium wages before and after the Lehman crisis, as well as the wage gap in absolute euro-amounts and as a percentage of equilibrium. In 2015 the average monthly wage in the Euro Area was €3,250; in Luxemburg it was €5,414, but the equilibrium level at €7,300 was even higher. By contrast, in Lithuania actual wages were only €1,090 against the equilibrium wage of €1,803. German wages of €3,316 are in the middle field with a gap of €146 below equilibrium, while Greek wages of €1,884 are €512 above equilibrium. In the Non-Euro Area wages are undervalued in all countries but Sweden. The mean relative wage gap in the out-countries is higher than in the Euro Area because of the larger weight of the transition economies in Central and Eastern Europe. In Romania and Poland, nominal wages are more than a third below their equilibrium level; but even within the Euro Area Lithuania, Slovakia and Latvia are more competitive. On average, Polish wages could go up by €579 per month without pushing the return on capital below the Euro Area. Among the old opt-out member states, the UK and Denmark have gained significant competitive advantages, while Sweden has reduced its handicap. Note that Denmark

[10] Note that flexible exchange rates make the series more volatile, but the effectiveness of a change in the exchange rate on competitiveness depends on the exchange rate elasticity of exports. A recent study by (Swarnali et al. 2015) shows that due to the formation of Global Value Chains this elasticity has significantly fallen. Hence, our competitiveness indicator may be a good measure for flexible exchange rate regimes as well.

Table 4.1 Average monthly wage in € 000

Monthly		Actual wage 1999	Actual wage 2007	Actual wage 2015	Change 1999–2007	Change 2007–2015	Equilibrium wage 1999	Equilibrium wage 2007	Equilibrium wage 2015	Change 1999–2007	Change 2007–2015	Wage gap in €000 1999	Wage gap in €000 2007	Wage gap in €000 2015	Wage gap in percent to equilibrium 1999	Wage gap in percent to equilibrium 2007	Wage gap in percent to equilibrium 2015
	European Union (28)	2.045	2.613	2.983	27.8 %	14.2 %	2.059	2.691	3.146	30.7 %	16.9 %	–0.014	–0.078	–0.162	–0.7 %	–2.9 %	–5.2 %
	Euro area (18)	**2.310**	**2.801**	**3.250**	**21.3 %**	**16.0 %**	**2.310**	**2.801**	**3.250**	**21.3 %**	**16.0 %**	**0.000**	**0.000**	**0.000**	0.0 %	0.0 %	0.0 %
1	Luxembourg	3.398	4.584	5.414	34.9 %	18.1 %	4.802	6.269	7.222	30.6 %	15.2 %	–1.404	–1.686	–1.807	–29.2 %	–26.9 %	–25.0 %
1	Belgium	3.072	3.829	4.490	24.6 %	17.3 %	3.037	4.028	4.759	32.6 %	18.1 %	0.034	–0.199	–0.268	1.1 %	–4.9 %	–5.6 %
1	Finland	2.526	3.236	3.936	28.1 %	21.6 %	2.632	3.421	3.911	30.0 %	14.3 %	–0.105	–0.184	0.025	–4.0 %	–5.4 %	0.6 %
1	Ireland	2.329	3.724	3.896	59.9 %	4.6 %	3.210	4.690	5.637	46.1 %	20.2 %	–0.881	–0.967	–1.741	–27.5 %	–20.6 %	–30.9 %
1	Netherlands	2.568	3.278	3.841	27.7 %	17.2 %	2.606	3.554	4.111	36.4 %	15.7 %	–0.038	–0.277	–0.270	–1.5 %	–7.8 %	–6.6 %
1	France	2.616	3.313	3.834	26.6 %	15.7 %	2.628	3.135	3.517	19.3 %	12.2 %	–0.012	0.178	0.318	–0.5 %	5.7 %	9.0 %
1	Austria	2.592	3.093	3.656	19.3 %	18.2 %	2.087	2.687	3.018	28.7 %	12.3 %	0.505	0.406	0.639	24.2 %	15.1 %	21.2 %
1	Germany	2.565	2.787	3.316	8.7 %	19.0 %	2.123	2.694	3.343	26.9 %	24.1 %	0.442	0.093	–0.027	20.8 %	3.4 %	–0.8 %
1	Italy	2.240	2.759	3.035	23.2 %	10.0 %	2.967	3.313	3.295	11.6 %	–0.5 %	–0.728	–0.553	–0.260	–24.5 %	–16.7 %	–7.9 %
1	Spain	1.833	2.370	2.655	29.3 %	12.0 %	1.800	1.909	2.447	6.1 %	28.2 %	0.034	0.460	0.208	1.9 %	24.1 %	8.5 %
1	Slovenia	1.189	1.769	2.102	48.8 %	18.8 %	1.540	2.297	2.645	49.1 %	15.1 %	–0.352	–0.528	–0.543	–22.8 %	–23.0 %	–20.5 %
1	Greece	1.369	2.068	1.884	51.1 %	–8.9 %	0.802	1.788	1.238	122.9 %	–30.8 %	0.567	0.280	0.646	70.7 %	15.7 %	52.2 %
1	Cyprus	1.384	1.890	1.868	36.6 %	–1.2 %	2.129	2.777	2.725	30.4 %	–1.9 %	–0.745	–0.887	–0.857	–35.0 %	–31.9 %	–31.5 %
1	Malta	1.095	1.514	1.858	38.2 %	22.8 %	1.390	2.137	2.720	53.7 %	27.3 %	–0.295	–0.623	–0.862	–21.2 %	–29.2 %	–31.7 %
1	Portugal	1.207	1.621	1.732	34.3 %	6.9 %	1.307	1.616	1.974	23.7 %	22.1 %	–0.100	0.004	–0.242	–7.7 %	0.3 %	–12.3 %
1	Estonia	0.379	1.056	1.476	178.5 %	39.7 %	0.426	1.292	1.621	203.7 %	25.4 %	–0.046	–0.236	–0.146	–10.9 %	–18.3 %	–9.0 %
1	Slovakia	0.350	0.888	1.302	153.7 %	46.6 %	0.508	1.673	2.498	229.0 %	49.3 %	–0.158	–0.785	–1.196	–31.1 %	–46.9 %	–47.9 %
1	Latvia	0.308	0.876	1.132	184.6 %	29.3 %	0.500	1.576	2.182	215.4 %	38.5 %	–0.192	–0.700	–1.050	–38.4 %	–44.4 %	–48.1 %
1	Lithuania	0.315	0.833	1.090	164.6 %	30.9 %	0.443	1.322	1.885	198.1 %	42.6 %	–0.129	–0.490	–0.795	–29.0 %	–37.0 %	–42.2 %
	Unweighted mean	*1.754*	*2.394*	*2.764*	*0.617*	*0.178*	*1.944*	*2.746*	*3.197*	*0.734*	*0.183*	*–0.190*	*–0.352*	*–0.433*	*–0.087*	*–0.131*	*–0.120*
	Standard deviation	*0.993*	*1.122*	*1.276*	*0.590*	*0.132*	*1.164*	*1.281*	*1.462*	*0.773*	*0.175*	*0.485*	*0.539*	*0.705*	*0.263*	*0.206*	*0.251*
2	Denmark	2.854	3.771	4.520	32.1 %	19.9 %	3.010	3.893	5.012	29.3 %	28.7 %	–0.156	–0.122	–0.491	–5.2 %	–3.1 %	–9.8 %
2	United Kingdom	2.632	3.675	3.789	39.6 %	3.1 %	2.507	3.687	4.258	47.1 %	15.5 %	0.125	–0.013	–0.469	5.0 %	–0.3 %	–11.0 %
2	Sweden	2.359	3.122	3.782	32.4 %	21.1 %	1.568	2.384	2.970	52.0 %	24.6 %	0.790	0.738	0.812	50.4 %	31.0 %	27.3 %
2	Croatia	0.800	1.289	1.427	61.1 %	10.7 %	0.951	1.688	1.695	77.6 %	0.4 %	–0.151	–0.399	–0.269	–15.8 %	–23.7 %	–15.8 %

Table 4.1 (continued)

		Actual wage			Change		Equilibrium wage			Change		Wage gap in €000			Wage gap in percent to equilibrium		
Monthly		1999	2007	2015	1999–2007	2007–2015	1999	2007	2015	1999–2007	2007–2015	1999	2007	2015	1999	2007	2015
2	Czech Republic	0.463	1.049	1.222	126.5 %	16.5 %	0.422	1.275	1.561	202.0 %	22.5 %	0.041	–0.226	–0.339	9.7 %	–17.7 %	–21.7 %
2	Poland	0.520	0.821	1.048	57.8 %	27.6 %	0.748	1.491	1.936	99.3 %	29.8 %	–0.228	–0.670	–0.888	–30.5 %	–44.9 %	–45.9 %
2	Hungary	0.474	1.038	1.000	119.0 %	–3.7 %	0.670	1.414	1.423	111.1 %	0.7 %	–0.196	–0.375	–0.423	–29.2 %	–26.6 %	–29.7 %
2	Romania	0.162	0.594	0.681	266.0 %	14.5 %	0.298	1.130	1.389	279.4 %	23.0 %	–0.135	–0.535	–0.709	–45.5 %	–47.4 %	–51.0 %
2	Bulgaria	0.166	0.317	0.575	91.3 %	81.3 %	0.254	0.612	0.809	141.2 %	32.2 %	–0.088	–0.295	–0.234	–34.6 %	–48.2 %	–28.9 %
	Unweighted mean	*1.159*	*1.742*	*2.005*	*0.917*	*0.212*	*1.159*	*1.953*	*2.339*	*1.154*	*0.197*	*0.000*	*–0.211*	*–0.335*	*–0.106*	*–0.201*	*–0.207*
	Standard deviation	*1.115*	*1.375*	*1.555*	*0.743*	*0.244*	*0.998*	*1.144*	*1.435*	*0.813*	*0.119*	*0.317*	*0.408*	*0.478*	*0.295*	*0.262*	*0.230*
3	United States	3.371	3.488	4.857	3.5 %	39.2 %	3.490	3.550	5.581	1.7 %	57.2 %	–0.119	–0.063	–0.724	–3.4 %	–1.8 %	–13.0 %
3	Japan	3.408	2.354	2.707	–30.9 %	15.0 %	2.913	2.099	2.590	–28.0 %	23.4 %	0.495	0.255	0.117	17.0 %	12.2 %	4.5 %

has a fixed exchange rate to the euro, but not the UK and Sweden. In the UK monthly wages could go up by 8 %, and in Denmark even 13 %, but in Sweden they would have to fall by 5 %.

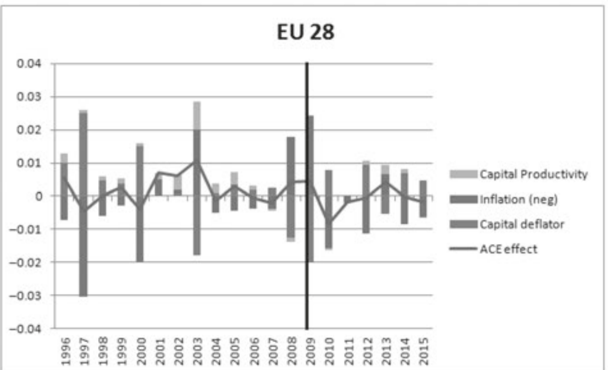
These wage imbalances are important. They provide an explanation for the different paces of growth and the different performances in overcoming the crisis. Undervalued countries ought to bring their wages up to equilibrium levels, while overvalued countries must increase their equilibrium wage by raising productivity. Figure 4.2 shows the decomposition of the average capital efficiency in each member state into the effects of capital goods prices, inflation, and physical capital productivity relative to the Euro Area. An overall ACE-effect close to zero means that the changes in the average capital efficiency were in line with the Euro Area.

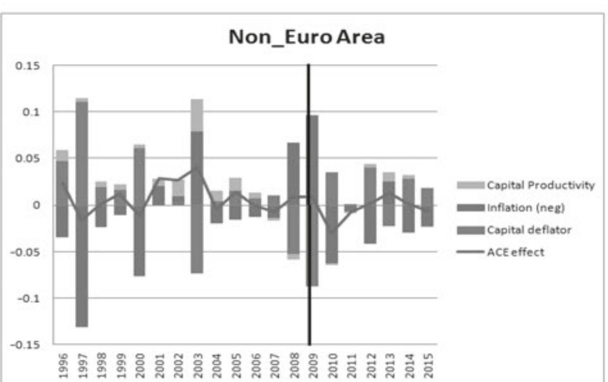
The information is summarised in Table 4.2, which shows the average annual performance of each ACE component in the four country groups as well as labour productivity for the period 1999–2015. Remember from Eqs. (4.5) and (4.6) that a negative sign for the ACE-effect will cause a rise in equilibrium wages. Thus, a negative price effect and a positive coefficient on capital productivity will reduce the ACE-effect and push up equilibrium wages. The price effect is negative if GDP inflation exceeds the increases in prices for capital equipment relative to the Euro Area.

Interesting features emerge. In Northern Europe the ACE effect has lifted equilibrium wages everywhere except in France. In the crisis countries, it is the opposite with the interesting exception of Ireland and Greece, which are both dominated by price effects. The three biggest losers, Italy, Spain and France cover about half of the Euro Area's GDP. In the new member states, capital efficiency has improved more than in the Euro Area, except in Estonia and Slovenia. On average, however, new member states within the Euro Area have performed better than those who have remain outside. The euro-opt-out countries all have improved their average capital efficiency.

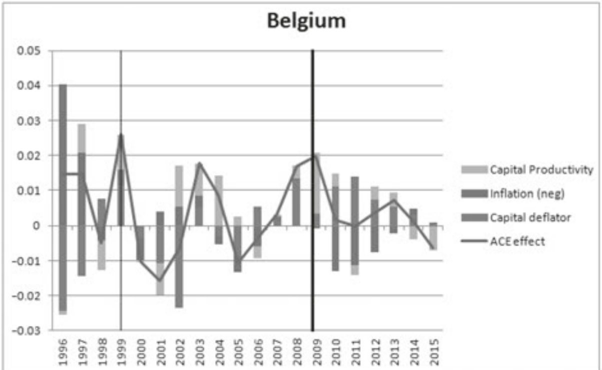
Price effects and capital productivity were equally responsible for this development in the north, although in Germany, capital productivity has dominated. In the crisis countries, price effects have masked half of the loss of capital productivity and in the new member states the price effect is significantly higher, especially outside the Euro Area. In the opt-out countries, the price effect is lower. It is interesting that in the Euro Area the price effect is dominated by inflation differentials, especially in

Aggregate





Euro Area



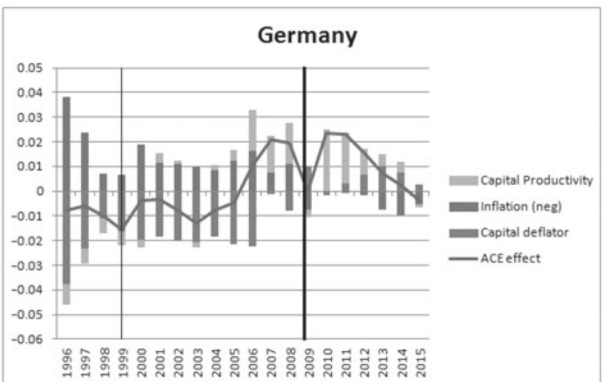


Fig. 4.2 Decomposition of capital efficiency effect

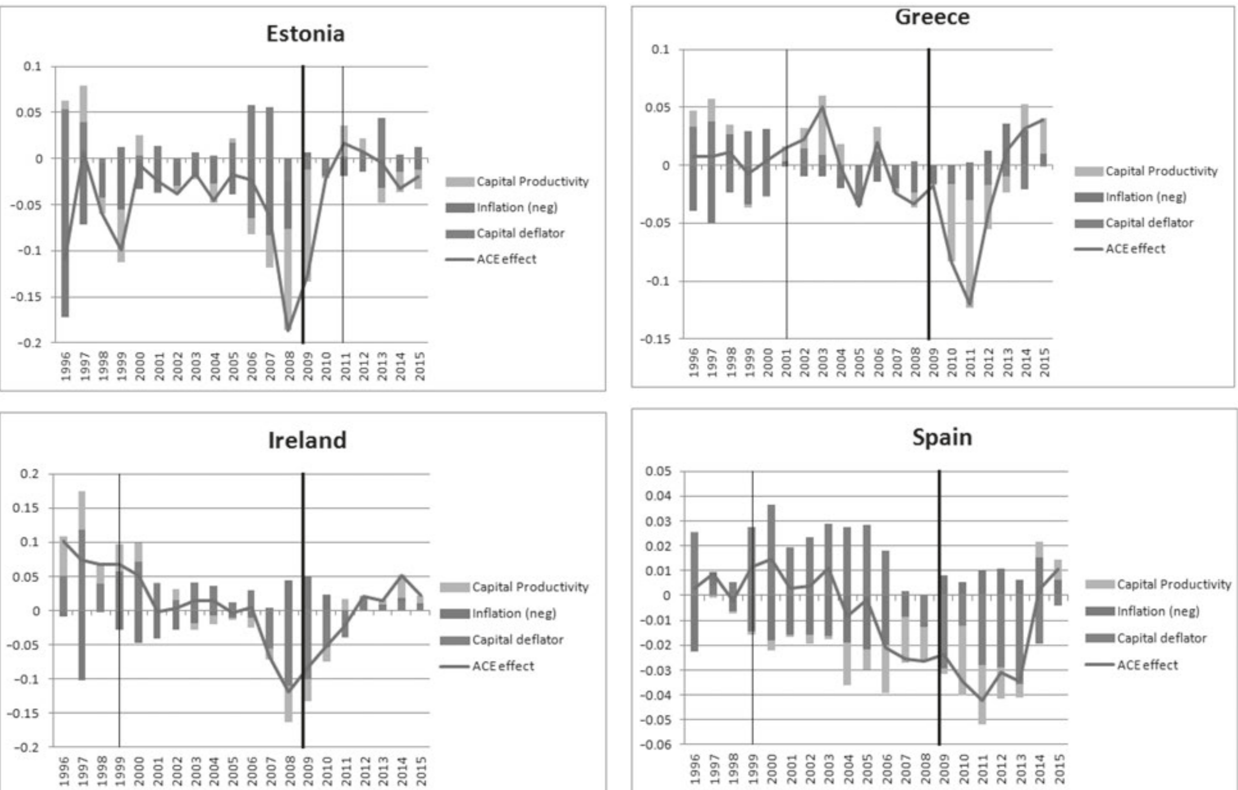


Fig. 4.2 (continued)

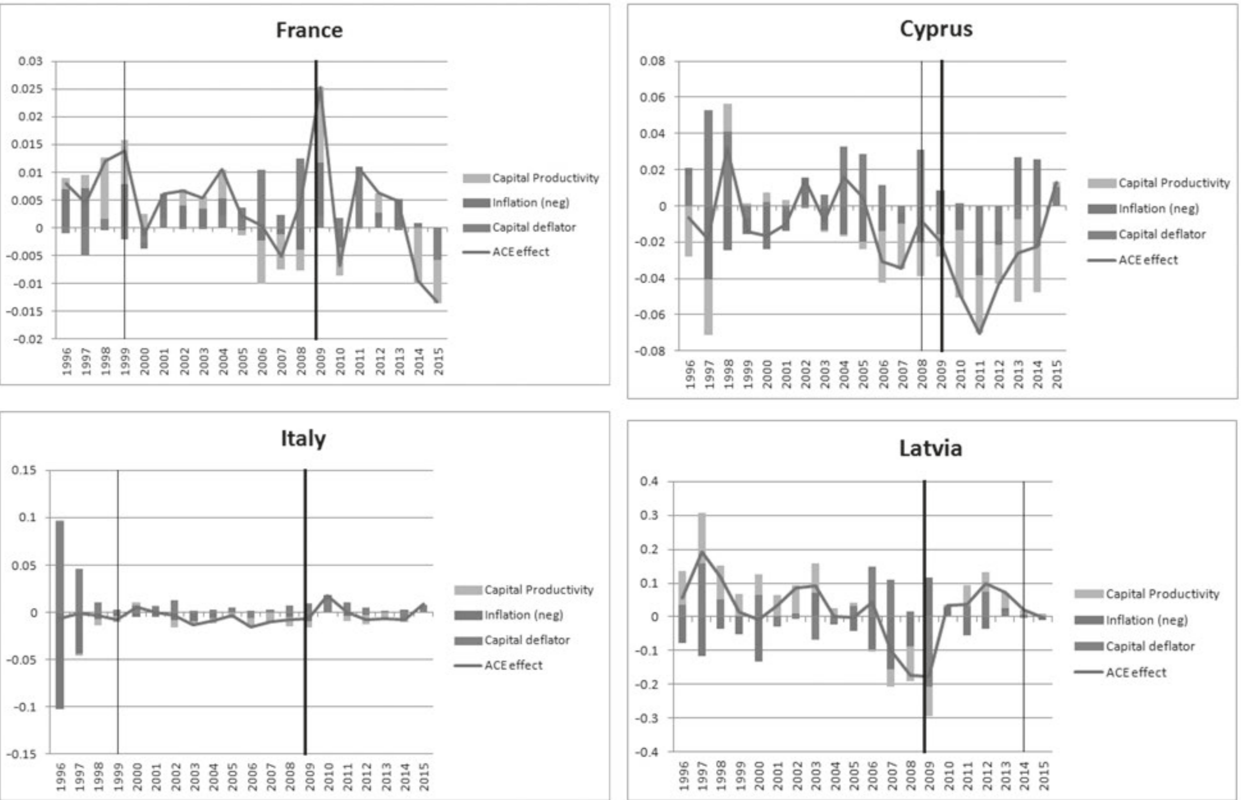
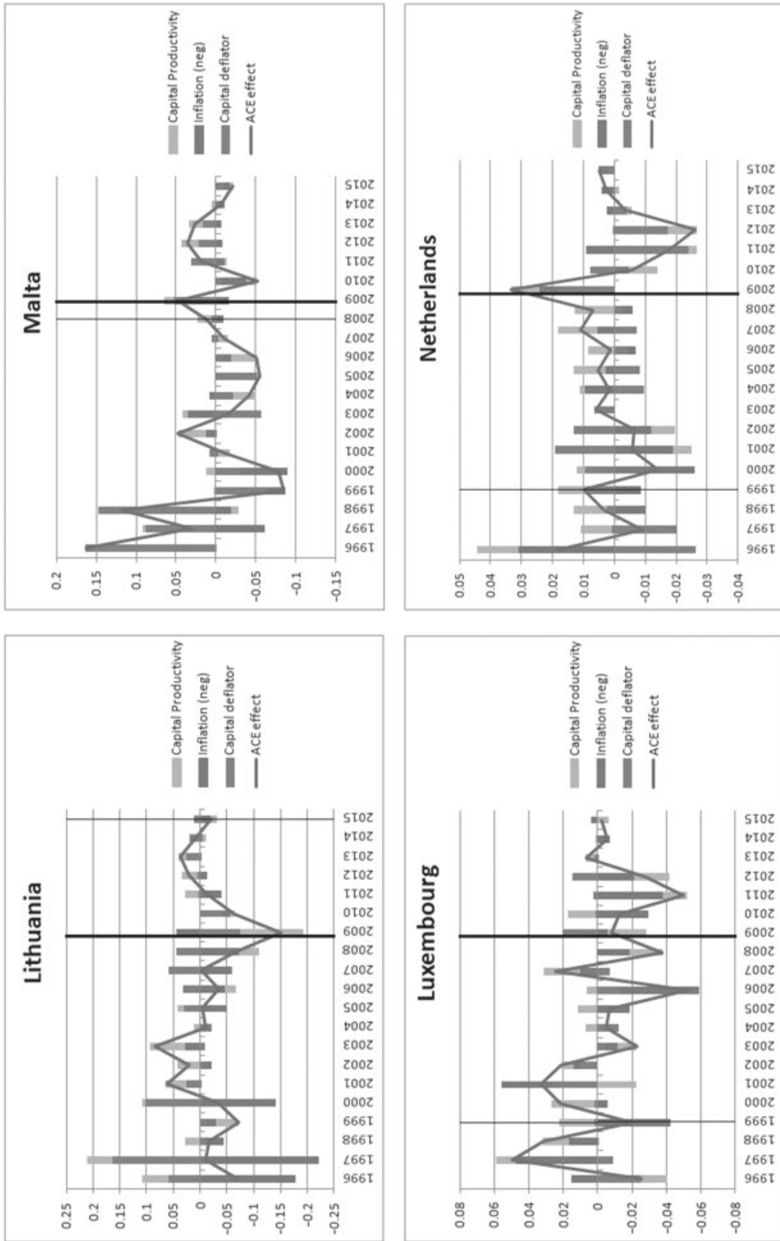


Fig. 4.2 (continued)



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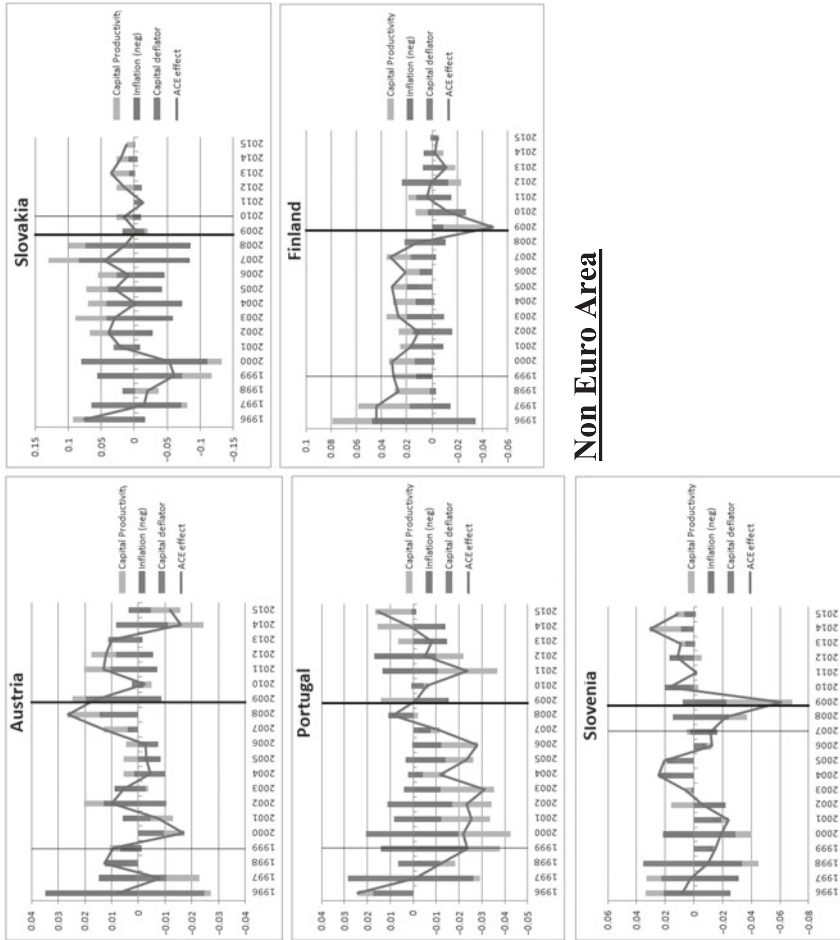

Fig. 4.2 (continued)

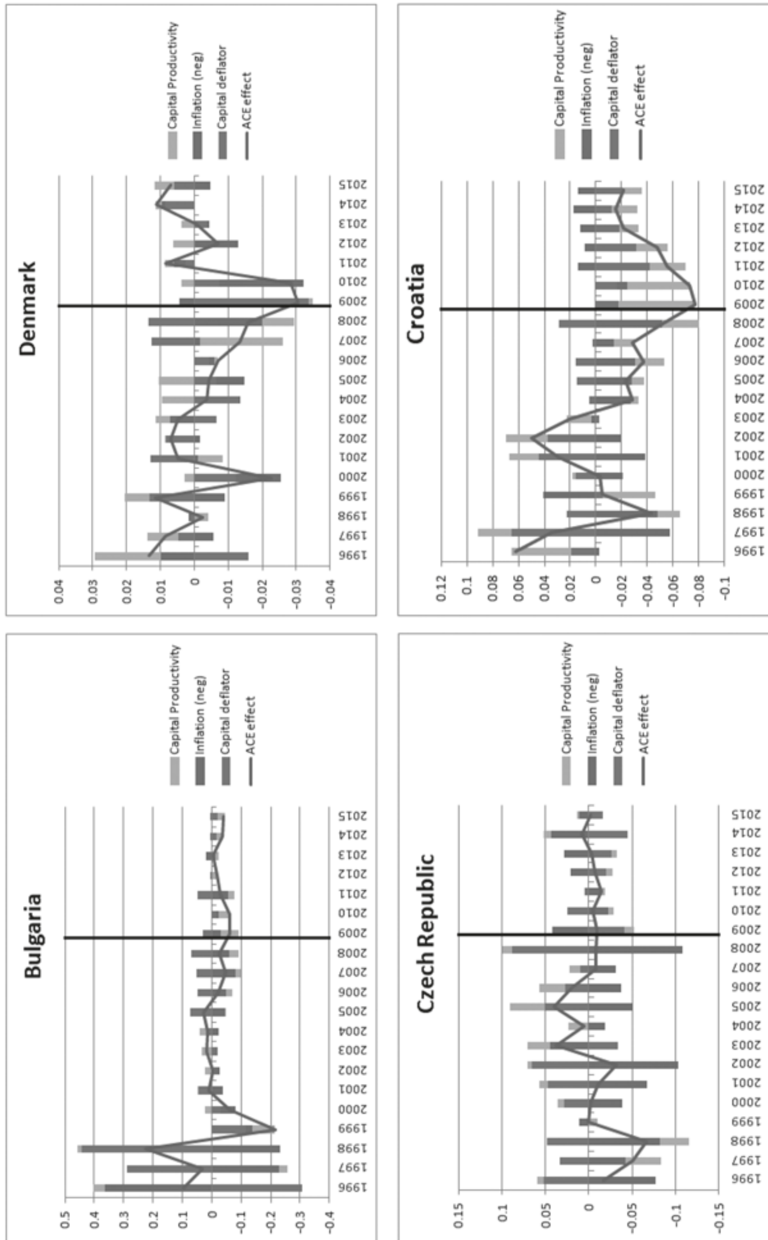

Fig. 4.2 (continued)

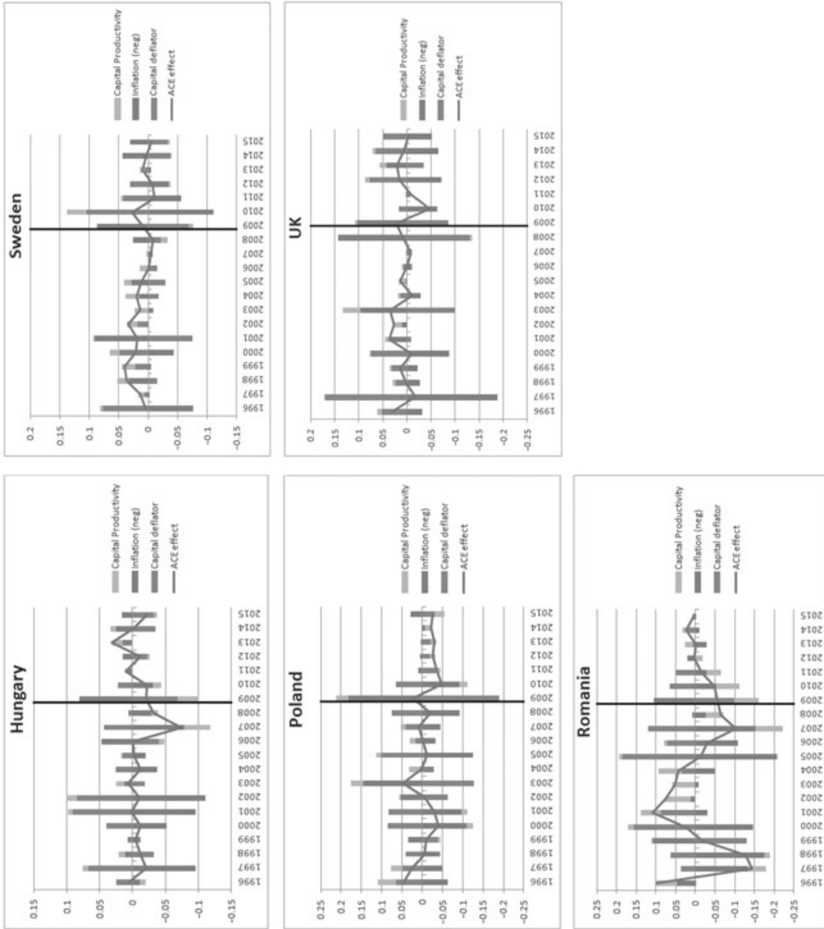

Fig. 4.2 (continued)

Table 4.2 Productivity effects on equilibrium wages

	Capital		Price	Capital	
	Deflator	Inflation	Effect	Productivity	ACE effect
Malta	−0.71 %	0.80 %	−1.51 %	0.12 %	−1.63 %
Germany	−0.75 %	−0.47 %	−0.27 %	0.65 %	−0.92 %
Luxemburg	0.27 %	1.13 %	−0.87 %	0.02 %	−0.89 %
Belgium	0.19 %	0.20 %	−0.01 %	0.32 %	−0.32 %
Netherlands	0.06 %	0.20 %	−0.14 %	0.17 %	−0.31 %
Finland	0.51 %	0.04 %	0.47 %	0.51 %	−0.03 %
Austria	0.19 %	0.04 %	0.15 %	0.15 %	−0.01 %
France	0.22 %	−0.16 %	0.38 %	−0.02 %	0.40 %
Northern Europe	0.00 %	0.22 %	**−0.23 %**	0.24 %	**−0.46 %**
Ireland	−0.07 %	0.33 %	−0.40 %	−0.09 %	−0.31 %
Greece	−0.61 %	0.01 %	−0.62 %	−0.37 %	−0.25 %
Portugal	0.08 %	0.59 %	−0.51 %	−0.77 %	0.26 %
Spain	0.25 %	0.53 %	−0.28 %	−0.85 %	0.57 %
Italy	0.44 %	0.28 %	0.16 %	−0.56 %	0.72 %
Cyprus	0.12 %	0.50 %	−0.38 %	−1.41 %	1.04 %
Crisis countries	0.04 %	0.37 %	**−0.34 %**	−0.68 %	**0.34 %**
Latvia	−1.04 %	2.63 %	−3.67 %	2.01 %	−5.68 %
Slovakia	2.16 %	2.84 %	−0.68 %	1.59 %	−2.27 %
Lithuania	1.14 %	2.53 %	−1.39 %	0.00 %	−1.39 %
Estonia	1.10 %	3.12 %	−2.02 %	−2.13 %	0.11 %
Slovenia	0.02 %	0.08 %	−0.05 %	−0.19 %	0.13 %
New members in	0.68 %	2.24 %	**−1.56 %**	0.26 %	**−1.82 %**
Czech Republic	0.99 %	1.70 %	−0.71 %	0.76 %	−1.47 %
Poland	−0.48 %	0.73 %	−1.21 %	−0.07 %	−1.14 %
Hungary	0.75 %	1.50 %	−0.76 %	−0.26 %	−0.49 %
Bulgaria	0.83 %	2.64 %	−1.81 %	−1.43 %	−0.39 %
Romania	3.47 %	3.62 %	−0.15 %	0.08 %	−0.23 %
Croatia	−0.01 %	0.75 %	−0.76 %	−1.52 %	0.76 %
New members out	0.92 %	1.82 %	**−0.90 %**	−0.41 %	**−0.49 %**
UK	−0.27 %	−0.17 %	−0.10 %	0.74 %	−0.84 %
Sweden	−0.22 %	−0.34 %	0.12 %	0.90 %	−0.79 %
Denmark	−0.06 %	0.49 %	−0.55 %	0.09 %	−0.64 %
opt-out	−0.18 %	−0.01 %	**−0.18 %**	0.58 %	**−0.76 %**

Source: Own calculations based on Ameco

the crisis countries, while the prices for capital equipment hardly affect competitiveness. In the new member states outside the Euro Area the cost of capital equipment is more of a handicap.

As Fig. 4.2 shows, the response to the Global Financial Crisis in 2008 was very diversified between countries and over time. While Germany

has greatly improved its capital efficiency, during the post-crisis demand boom most other countries have seen their capital productivity fall, especially those implementing austerity policies. This was particularly damaging in the crisis countries, but also in the new member states outside the Euro Area. In the opt-out countries, capital productivity does not make a large contribution, except in Denmark.

4.4 Conclusion

Our new index of wage competitiveness reveals some interesting stylized facts. First of all, it shows that the major dividing line is not between north and south, but between new and old member states in the European Union. With an unweighted mean growth rate of 3.26 % between 2008 and 2015, Central and Eastern Europe is the fastest growing region in the EU, while the old member states had a negative growth rate of 1.45 % on a similar count. This positive performance in the east is explainable by the transformation of productive capacities in the transition to a market economy, and it is justifiable by the need for catch-up growth to reach average EU per capita income. But because it is based on deep wage undervaluations, this development causes distortions in the European labour market, which have undermined the equally justifiable catch-up growth in the south. When investment from the north is largely channelled to the east, it is lacking in the south.

Second, Germany has reduced its overvaluation inherited from its unification, but its undervaluation is relatively modest compared to Eastern Europe. The Hartz IV reforms in the mid-2000s have kept actual wage increases below the improvements in equilibrium wages, which were pushed up by improvements in capital productivity relative to the Euro average. There is strong evidence that outsourcing to the east has been one of the factors that have improved capital productivity and equilibrium wages.[11] The opposite dynamic is at work in France, which has steadily lost its previous competitive advantage because actual wages have risen too fast in the early 2000s and capital productivity has been lagging

[11] The evidence is forthcoming in: (Collignon and Esposito 2015).

behind. In Italy the efficiency of the national capital stock has deteriorated for nearly two decades and this has lowered the equilibrium wage and undermined the country's competitiveness.

Third, being outside the Euro Area does not yield any significant comparative advantages. In fact, it is rather the opposite. The equilibrium wage has marginally improved in the out countries, which is not surprising given that most of them are transition economies, but actual wages have grown more inside than outside the currency union. The price effects are important in the transition economies, but they are likely to disappear over time.

Fourth, wage-led growth by stimulating demand through wage increases is a viable strategy in some countries, but not all. Roughly half of the Euro Area in GDP terms suffers from wages above the equilibrium level, which leaves the other half to increase their wages without major loss of competitiveness.

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5

The Institutional Architecture of EU Financial Regulation: The Case of the European Supervisory Authorities in the Aftermath of the European Crisis

Gianni Lo Schiavo and Alexander Türk

5.1 The Development of EU Financial Regulation and Supervision: From the Lamfalussy Committees to the Establishment of the European Banking Union

The idea of a harmonised and comprehensive regulatory framework for national financial law within the European Community can be first identi-

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L.S. Talani (ed.), *Europe in Crisis*,
DOI 10.1057/978-1-137-57707-8_5

fied in the Segré report.[1] The Commission in its seminal 'White Paper on completing the internal market' emphasised the harmonisation of financial services.[2] In the Financial Service Action Plan (FSAP)[3] the European Union (EU) seriously engaged with the pursuit of a more comprehensive system of financial regulation at European level with the view to set out a new legislative agenda to ensure the free movement of capital and financial services.

At the same time, the years following the FSAP saw the establishment of the Lamfalussy decision-making process.[4] It was a four-level structure aimed at harmonising financial supervision and regulation in the European Union. Level 1 provided for the adoption of framework legislation by the European Parliament and the Council in the context of financial regulation. Level 2 was envisaged for the drafting of implementing acts setting out the more technical aspects of financial legislation. This was the task of the Commission in cooperation with national administrations within the framework of the comitology regime.[5] Level 3 was conceived as a 'pole of cooperation' between national authorities and took the form of committees where national competent authorities convened to discuss the application of European legislation. The committees, as established from 2001 to 2003, were the Committee of European Securities Regulators (CESR), the Committee of European Banking Supervisors (CEBS) and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS). Both the Commission and the committees played a central role in financial regulation. Nonetheless, the latter acted on behalf of national supervisors and did not have intrusive powers of supervision, monitoring or sanction over national authorities or financial entities. Thus, their main tasks were three: the improvement of coordination among national regulators, their advisory role to the Commission and their assistance to the implementation of European

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[1] Segré Report, *The Development of a European Capital Market,* (1966) available at http://ec.europa.eu/economy_finance/emu_history/documentation/chapter1/19661130en382develeurocapitm_a.pdf (last accessed 24 November 2015).

[2] European Commission, *Completing the Internal Market*, (85)310, (1985).

[3] European Commission, *Financial Services Action Plan*, COM(1999)232, (1999).

[4] For an extensive account of the development of the institutional structure of EU securities regulation see Moloney, *EU Securities and Financial Markets Regulation*, 942–1030.

[5] See Council Decision, 1999/468, later amended by Council Decision, 2006/512.

legislation in the Member States. At level 4 the Commission would ensure compliance with Union law.

Although the Lamfalussy structure has been, overall, successful, shortcomings were identified in particular in relation to level 3 Committees.[6] For instance, the strong 'national imprinting' of its functions or the absence of legally binding powers have proved to be inadequate to allow for an efficient coordination amongst national supervisors. It was argued that the level 3 Committee system lacked institutional capacity to co-ordinate an effective response to cross-border financial crises.[7]

The outbreak of the recent financial crisis has dramatically changed financial regulation and supervision in the European Union. The need for institutional reforms of EU financial regulation was highlighted by important European initiatives that showed how the established committee system was inadequate to tackle the risks of cross-border financial crises and to avoid spillover effects. In February 2009, the de Larosière Report[8] was published. It outlined the inefficiencies of the existing European financial supervisory model and called for a more institutionalised system of micro-prudential supervision and for the establishment of a macro-prudential system of supervision.[9] It appeared that the problems of the level 3 committee structure were the absence of legally binding powers, insufficient level of accountability and transparency, and the lack of real independence from national and stakeholder interests.[10] The Lamfalussy committee structure needed to be reformed in order to ensure financial stability and to provide more structured financial integration at the European level.[11]

The Council supported the de Larosière conclusions on the European System of Financial Supervisors[12] and paved the way for the Commission

[6] Moloney, *EU Securities and Financial Markets Regulation*, 1107.

[7] See Ferran, "Understanding the New Institutional Architecture of EU Financial Market Supervision", Chap. 6.

[8] de Larosière, Report, (25 February 2009), available at http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf (last accessed 24 November 2015).

[9] Ibid, 39–42.

[10] Ibid, 54–55.

[11] Ibid, 46–48.

[12] Council, "Council conclusions on strengthening EU financial supervision", (9 June 2009), para.7; European Council, "Presidency conclusions", (18/19 June 2009), para.20.

proposing new legislative measures. In September 2009, the Commission proposed four regulations aimed at creating a new European System of Financial Supervision (ESFS) consisting of a European Systemic Risk Board (ESRB), which would monitor macro-prudential risks in the EU, and three European Supervisory Authorities (ESAs), the European Banking Authority (EBA), the European Securities and Market Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA). The proposals were adopted in 2010 and the ESAs, whose functions include intervention-based oversight over national competent authorities and market participants as well as preparatory law making powers in EU financial legislation,[13] were formally established as of 1 January, 2011.[14]

Five years after the establishment of the ESAs, the European financial framework has undergone further substantial institutional reforms. In particular, the creation of the European Banking Union (EBU) with a more centralised attribution of regulatory and supervisory powers at Union level has been an important evolution of the EU financial architecture. The conferral of unprecedented supervisory powers to the ECB[15] and the establishment of a new European agency, the Single Resolution Board, for resolution purposes[16] have reshaped the governance system of EU financial regulation and supervision. Furthermore, the Commission has launched a new action plan for the establishment of a European Capital Markets Union.[17]

Against this background, this chapter will discuss the essential role that the ESAs now play within the institutional architecture of EU financial regulation, and in particular their considerable regulatory powers. An assessment of the new regulatory tools in the financial sector for the ESAs, however, cannot be considered in isolation from the constitu-

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[13] See European Commission, Communication, *European Financial Supervision*, COM(2009)252, (2009).

[14] Regulation (EU) No 1093/2010; Regulation (EU) No 1094/2010; Regulation (EU) No 1095/2010 (hereinafter the 'ESA Regulations').

[15] Council Regulation (EU) No 1024/2013.

[16] Regulation (EU) No 806/2014.

[17] European Commission, *Action Plan on Building a Capital Markets Union*, (30 September 2015) available at http://ec.europa.eu/finance/capital-markets-union/docs/building-cmu-action-plan_en.pdf (last accessed 23 May 2016).

tional and institutional framework in which they have been established. It is submitted that the drive for greater efficiency in the regulation of financial services has the potential to undermine important constraints imposed by this framework. This view has obvious implications for the interpretation and the assessment of the constitutional validity of the legal provisions regarding the ESAs new tools.

The chapter will proceed as follows. Firstly, it will set out the constitutional and institutional framework, which limits the exercise of the ESAs powers. Secondly, it will assess the main regulatory tools of the ESAs with particular focus on the technical standards, soft-law measures and on supervisory powers before offering some conclusions.

5.2 The ESAs in Light of the EU Constitutional Framework

The creation of the ESAs has proved to be a further evolution in the current process of agencification in the EU. However, it still raises questions as to the ESAs' effectiveness in financial market regulation and supervision in light of the normatively important limitations of the ESAs. This section will explore the most controversial issues arising from the establishment of the ESAs with particular focus on the constraints imposed by the principles of conferral and institutional balance, as well as by the normative demands of democratic legitimacy.

5.2.1 Article 114 TFEU and the Establishment of EU Agencies: The Legal Basis Constraint

Traditionally, the establishment of agencies in the EU legal order has been made through recourse to Article 352 TFEU (former 308 EC).[18] More recently, depending on the sector, specific legal bases have been used to create new agencies. Extensive use has been made in particular of Article 114

[18] Article 352 TFEU is the flexibility clause empowering the Council to adopt appropriate measures if the EU Treaties do not provide for the necessary powers.

TFEU, which provides the legal basis for measures for the harmonisation or approximation of national rules in order to contribute to the establishment and functioning of the internal market.[19] The novel use of establishing agencies on the basis of this provision has given rise to considerable litigation before the Court of Justice of the European Union (CJEU).

In *Smoke Flavourings*, the Court held that the system for the adoption of the authorisation for smoke flavourings for foods, which gave certain powers to the European Food Safety Authority (EFSA) and to the Commission, did not run counter to Article 114 TFEU as a legal basis.[20] In this respect, the Court emphasised that 'by the expression "measures for the approximation" in Article 95 EC [now 114 TFEU] the authors of the Treaty intended to confer on the Community legislature a discretion, depending on the general context and the specific circumstances of the matter to be harmonised, as regards the harmonisation technique most appropriate for achieving the desired result, in particular in fields which are characterised by complex technical features.'[21]

In the *ENISA* case[22] the Court found that it was within the discretion of the EU legislator to provide for the establishment of an agency, in this case the European Network and Information Security Agency (ENISA), 'responsible for contributing to the implementation of a process of harmonisation in situations where (…) the adoption of non-binding supporting and framework measures seems appropriate'.[23] The Court required however that the tasks of the agency be closely linked to the subject matter which the legislation intended to harmonise. This requirement was met in particular where the agency provided services for the national authorities and national operators 'which affect the homogenous implementation of harmonising instruments and which are likely to facilitate their application'.[24]

[19] For a general monograph on Article 114 TFEU see Maletic, *The Law And Policy of Harmonisation in Europe's Internal Market*.

[20] Case C-66/04, *United Kingdom v European Parliament and Council* (Smoke Flavourings).

[21] Ibid, para.45.

[22] Case C-217/04, *United Kingdom v. Council and European Parliament* (ENISA case).

[23] Ibid, para.44.

[24] Ibid, para.45.

The ESA Regulations, in their respective preambles, justify recourse to Article 114 TFEU on the basis that '[t]he purpose and the tasks of the [Authorities]—assisting national supervisory authorities in the consistent interpretation and application of Union rules and contributing to financial stability necessary for financial integration—are closely linked to the objectives of the Union *acquis* concerning the internal market for financial services'.[25] Even though the reference in the recital to the *ENISA* judgment suggests that Article 114 TFEU might be used as the legal basis for the new ESAs, the considerable increase of regulatory and supervisory powers, including the power to adopt binding legal acts, were difficult to reconcile with the *ENISA* ruling.

Most recently, the role of Article 114 TFEU has been examined in the context of a challenge by the government of the United Kingdom against certain powers conferred to the ESMA in financial markets regulation.[26] The significance of the case lies in its assessment of the use of Article 114 TFEU for the newly conferred powers to the ESAs. The Court considered whether the provision of Article 28 of the Short Selling Regulation[27] (SSR) could be adopted on the basis of Article 114 TFEU.

Following its *ENISA* ruling, the Court found that the EU legislator had a wide degree of discretion in adopting approximation measures, including delegation to European agencies of the power to adopt measures of approximation that require the special professional and technical expertise of those agencies. In contrast with the *ENISA* ruling, the Court made it clear that EU agencies could also be entrusted with the power to adopt binding legal acts, because 'the approximation of general laws alone may not be sufficient to ensure the unity of the market.'[28] This included the power of agencies to adopt legal acts that were binding for participants in financial markets. The case law on Article 114 TFEU has therefore been rightly characterised as being permissive, not only of a greater integration of the market, but also of a 'more centralized para-

[25] See Recital 17 of the ESA Regulations.

[26] Case C-270/12, *United Kingdom v Parliament and Council* (Short Selling). See Lo Schiavo, "A Judicial Re-Thinking on the Delegation of Powers to European Agencies under EU Law?", 315.

[27] Regulation 236/2012.

[28] Case C-270/12, para.106.

digm of market harmonization.'[29] Without providing a clear definition of 'measure for the approximation', the Court's approach shows that it prefers to defer on this point to the action of the EU legislator and that it only intends to exercise limited judicial review.[30]

The Court's deference to the EU legislator is also apparent in the second part of its analysis of Article 114 as a legal basis, which concerned the requirement that the Union measures had to have as their 'object the establishment and functioning of the internal market'. The Court referred to its case law specifying that measures under Article 114 TFEU must genuinely improve the conditions for the establishment and functioning of the internal market. The Court, in contrast to its Advocate-General,[31] had no difficulty in finding that this condition was met. The Court held that ESMA's intervention in the financial markets in respect of short selling and credit default swaps was 'intended to prevent the creation of obstacles to the proper functioning of the internal market and the continuing application of divergent measures by Member States'.[32]

Overall, the Court's case law on the use of Article 114 TFEU provides the EU legislator with a broad framework not only for the adoption of substantive measures, but also for centralised institutional responses by EU agencies to obstacles in the internal market. In this sense, it has been noted that the use of Article 114 TFEU is 'attractive because it allows for flexible structures and far-reaching conferral of powers'.[33] Others have, however, pointed out that the ESAs have been established on a rather precarious legal basis for radical institutional reform.[34] What is certainly true is that in the context of financial supervision and regulation, Article 114 TFEU has acquired a role that was inconceivable before the outbreak of the financial crisis.

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[29] Maletic, *The Law and Policy of Harmonization in Europe's Internal Market*, 38.

[30] See*, e.g.*, Case C-343/09 *Afton Chemical Limited v Secretary of State for Transport*.

[31] See Opinion of AG Jääskinen in Case C-270/12, para. 37, where he argued that 'the conferral of decision making powers under that article on ESMA, in substitution for the assessments of the competent national authorities, cannot be considered to be [such] a measure'.

[32] Case C-270/12, para.114.

[33] Hofmann and Morini, "The pluralisation of EU executive—constitutional aspects of "Agencification", 428.

[34] See Ferran, "Understanding the New Institutional Architecture of EU Financial Market Supervision", Chap. 6.

5.2.2 EU Institutional Balance and the Limits of Discretion: The Meroni Constraint

Close attention also needs to be paid to assess whether and to what extent the powers granted to the ESAs conform to the principle of institutional balance in EU law. This is at the heart of the Court's *Meroni* doctrine, which has imposed a considerable constitutional constraint on the powers of EU agencies.

European agencies have been shaped in different periods of the European integration process,[35] yet the *Meroni* doctrine, which prohibits the granting of discretionary powers to EU agencies, has been considered as the main obstacle to the creation of fully-fledged regulatory agencies under EU law. The main challenge has been to 'balance the functional benefits and independence of agencies against the possibility of them becoming "uncontrollable centres of arbitrary powers." '[36] Therefore, the constraints arising from the institutional balance in the EU constitutional system have been seen as central for the conferral of powers to EU agencies.

In its core paragraph, the Court in *Meroni* held that 'the consequences resulting from a delegation of powers are very different depending on whether it involves clearly defined executive powers (…), or whether it involves a discretionary power, implying a wide margin of discretion which may, according to the use which is made of it, make possible the execution of actual economic policy.'[37] The Court suggested that a delegation of the first kind—clearly defined executive powers—does not appreciably alter the consequences involved in the exercise of the powers concerned. But a delegation of the second kind—discretionary power—would produce an actual transfer of responsibility and hence impinge on the principle of institutional balance.

The legacy of the Court's *Meroni* ruling has been immense in EU constitutional law. The *Meroni* doctrine enshrined in the judgment 'has stood

[35] See, *e.g.*, Geradin and Petit, *The Development of Agencies at EU and National Levels: Conceptual Analysis and Proposals for Reform*, 37; Hoffmann and Morini, "The pluralisation of EU executive—constitutional aspects of "Agencification", 419.

[36] Opinion of AG Jääskinen in Case C-270/12, para.19.

[37] Case C-9/56, *Meroni v Haute autorité,* 152.

for . . . 50 years as a constitutional limit to delegation.'[38] In the face of this restrictive approach to the delegation of powers to Union agencies, some authors have raised concerns about the continued validity of the *Meroni* doctrine. Majone maintains that agencies constitute the essence of a regulatory estate that should be added to other estates in the EU.[39] Chiti argues that the institutional balance to which the Court referred in *Meroni* is a fluid concept that should be reinterpreted over time by the Court.[40] Accordingly, he asserts that it is now time to give discretionary powers to agencies and move beyond a strictly legal reading of *Meroni*.[41] Griller and Orator argue for a flexible interpretation of the *Meroni* doctrine.[42] Chamon suggests that the *Meroni* case is a product of an European Coal and Steel Community (ECSC) framework that is incomparable to the current state of EU integration.[43] Yet, these arguments have not been successful in limiting the predominance of a '*Meroni*-consistent' approach to the delegation of powers in European case law and legislation.

Against this background, the *Short Selling* judgment can be seen as a reaffirmation and, at the same time, a reinterpretation of the *Meroni* doctrine in Union law by applying a more flexible standard for assessing the delegation of powers to EU agencies. The Court indicated that the application of the *Meroni* doctrine could be maintained while keeping in mind that the original *Meroni* situation, concerned as it was with the delegation of powers to bodies governed by private law, was different from the delegation to Union agencies established by the EU legislator.[44]

The Court found that the powers granted to the ESMA under Article 28 of the SSR were 'precisely delineated and amenable to judicial review in the light of the objectives established by the delegating authority'.[45]

[38] Craig, *EU Administrative Law,* 155.

[39] See Majone, "The Rise of the Regulatory State in Europe", 95.

[40] Chiti, "An Important Part of the EU's Institutional Machinery: Features, Problems and Perspectives of European Agencies", 1423.

[41] Ibid, 1424.

[42] Griller and Orator, "Everything under Control? The "Way Forward" for European Agencies in the Footsteps of the Meroni Doctrine", 34–35.

[43] See Chamon, "EU Agencies between Meroni and Romano or the Devil and the Deep Blue Sea", 1059.

[44] Case C-270/12, para.43.

[45] Ibid, para.53.

This signifies that the *Meroni* doctrine still exists, but now with flexible contours. The Court held that limitations on discretionary powers and judicial control mechanisms are sufficient to make the delegation of powers to European agencies compliant with the *Meroni* doctrine. The Court was able to 'restyle' the *Meroni* doctrine and move beyond the doctrine's straitjacket—as long as a *purely* discretionary power is not delegated to a European agency and as long as some institutional safeguards are guaranteed.

The Court's clean bill of health for the powers granted under Article 28 of the SSR is, however, not without concerns. Firstly, the limitations enshrined in Article 28 paragraph 2 of the SSR contain rather vague legal concepts, such as a threat 'to the orderly functioning and integrity of the financial markets' or 'to the stability of the whole or part of the financial system in the Union'. Secondly, it implies to some extent a judgment-based assessment of whether the threat has been adequately addressed by the national competent authority. Arguably, neither the factors in Article 28 paragraph 3 of the SSR, which ESMA must take into account when making its decision, nor the procedural constraints in Article 28 paragraphs 4 and 5 of the SSR, in any way eliminate a judgment-based evaluation, which ESMA is required to carry out. This is all the more relevant, as this kind of expert-led evaluation will reduce the scope for judicial review.[46] Thirdly, the emphasis on the constraints imposed by Regulation 918/2012, which is the delegated act adopted by the Commission based on Article 30 of the SSR[47] setting out more specific conditions for the exercise of the ESMA's powers under Article 28 of the SSR, underestimates the impact of 'technical' advice provided by ESMA for the drafting of the regulation.

[46] See Case T-187/06, *Schräder v CVPO*, para.63.

[47] See Article 24 of Regulation 918/2012.

5.2.3 ESAs and the Partial Lack of Democratic Legitimacy

It is commonly agreed that the considerable powers entrusted to EU agencies, and in particular the ESAs, need to be underpinned by guarantees for democratic legitimacy.[48] The ESAs's claim to democratic legitimacy can hardly be based on input legitimacy, but is rather reliant on an output-oriented dimension of legitimacy.[49] This is in particular the case for the level of independence and, more importantly, accountability of the ESAs. These are interdependent as 'a balance needs to be struck between a sufficient degree of independence to guarantee objective and consistent decision making on the one hand and the creation of adequate and effective accountability mechanisms to ensure that the supervisory authorities exercise their powers in accordance with their legal mandates on the other hand'.[50]

The principle of independence is mentioned in the ESA Regulations where it is stated that each authority 'shall act independently and objectively and in the interest of the Union alone'.[51] The importance of independence is, however, not sufficient to guarantee that the demands of democratic legitimacy *vis-à-vis* the European Parliament and the European citizens are met. This is why accountability plays an important role in ensuring, to some extent, the democratic legitimacy of the ESAs. The principle of accountability is defined as the 'relationship between an actor and a forum, in which the actor has the obligation to explain and justify his or her conduct, the form can pose questions and pass judgment, and the actor might face consequences'.[52] This acts as a fundamental principle in institutional design. Applied to the ESAs, it has mainly a threefold dimension: functional, judicial, and financial.

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[48] Griller and Orator, "Everything under Control? The "Way Forward" for European Agencies in the Footsteps of the Meroni Doctrine", 23.

[49] Ibid, 21.

[50] Lavrijssen and Ottow, "Independent Supervisory Authorities: a fragile concept", 421. See also Adamski, "The ESMA doctrine: a constitutional revolution and the economics of delegation", 813.

[51] ESA Regulations, Article 1.

[52] Bovens, "Analysing and assessing accountability: a conceptual framework", 450.

Functional accountability implies that ESAs shall carry out a number of reporting and reviewing processes *vis-à-vis* the Commission, the European Parliament and the Council. The annual reporting is of particular interest as it gives an outlook on all the ESAs's activities and is an effective instrument to assure that 'the forum can pose questions and pass judgment'.[53] This allows the European Parliament to play a role in the guarantee of a certain level of democratic legitimacy for the ESAs.

Judicial accountability ensures that the ESAs's activities are subject to judicial review. The ESAs's decisions can be challenged before a Board of Appeal and before the Union courts. The Board of Appeal is a special organ created jointly for the ESAs and has the function of an independent administrative body, which pronounces decisions.[54] In case of failure to contest a decision of the Board of Appeal or when there is no right of appeal before the Board of Appeal, proceedings may be brought before the Union courts.[55] The process has thus two levels of judicial review where the second one is given to the main judicial body in the EU. The level of judicial accountability appears sound and guarantees extensive judicial review of the ESAs's decisions.

Financial accountability concerns the budget and the financial provisions of the ESAs. ESAs are subject to the general financial provisions applicable to EU bodies and they are subject to the control of the Commission and the Court of Auditors. The ESAs's revenues are made of obligatory contributions from national financial authorities, subsidies from the EU budget, and any fees paid to it in the cases specified by EU measures.[56] These measures of financial accountability show that the budgetary and financial provisions have been duly taken into account to find the proper balance in controlling the ESAs's activities.

Overall, the ESAs do not have the same democratic legitimacy as EU institutions, but there are still sufficient safeguards allowing ESAs to exercise some degree of output-oriented democratic legitimacy.

[53] *Ibid.*

[54] See Article 60 of the ESA Regulations.

[55] See Article 61 of the ESA Regulations.

[56] See Article 62 of the ESA Regulations.

5.3 Rule-Making Powers and Procedures: The ESAs' Regulatory and Supervisory Tools

As compared to the former Lamfalussy level 3 committees, the ESAs have seen a considerable increase in tasks and powers in the regulation and supervision of the financial sector. In addition to providing technical advice on delegated acts and implementing acts adopted by the Commission, the ESAs play a central role in the drafting of technical standards, which take the form of regulatory technical standards and implementing technical standards. The ESAs can also adopt a vast array of soft-law measures, which contribute to the shaping of EU financial regulation. For the purpose of supervision and enforcement of EU financial law they have been given the power to adopt binding decisions directly addressed to market participants allowing them, in exceptional circumstances, to bypass the national competent authorities. The next section will discuss the extent of these powers and the procedures in which these acts are adopted in light of the three constraints on the ESAs outlined in the previous part.

5.3.1 Binding Regulatory Tools: Technical Standards and Their Constitutional Challenges

The preparation of draft technical standards is one of the most important regulatory powers the ESAs possess. The central role of the ESAs in the adoption of technical standards enhances the efficiency of the regulation of financial services, which is a technically complex and rapidly changing part of the Union's financial market, by making use of the expertise of EU agencies. The extensive conferral of powers to draft technical standards[57] requires, however, some reflections on their role in the EU financial architecture.

[57] For instance Regulation 575/2013 (the "CRR") contains some 59 legal bases for the adoption of DRTS and 21 for DITS by EBA; Directive 2013/36 (the "CRD IV") contains some 13 legal bases for DRTS and 11 for DITS by EBA.

ESAs can propose draft regulatory or implementing technical standards (hereinafter 'DRTS' and 'DITS') which, following the Commission's endorsement, will take the form of delegated or implementing acts. The ESAs' role in the creation of technical standards is considerable as, in contrast with their predecessors, ESAs' input will be direct and unmediated at the drafting stage.[58] The categories of DRTS and DITS reflect the distinction between delegated acts and implementing acts under Articles 290 and 291 TFEU. The former are governed by Article 290 TFEU and they shall consist of norms aimed at establishing 'a single rulebook [and] a level playing field and adequate protection to depositors, investors and consumers across the Union'.[59] The latter follow the regime set out in Article 291 TFEU for the adoption of implementing acts. The power to develop DRTS and DITS has clear limitations as these 'shall not imply strategic decisions or policy choices' and their 'content shall be delimited by the legislative acts on which they are based'.[60] While these limitations aim to provide political reassurance that the conferral of such powers to the ESAs is compatible with the ruling in *Meroni*, it may be argued that the ESAs enjoy a *de facto* regulatory power, often involving policy choices, in the adoption of such acts with the Commission having only limited opportunities to reject their draft measures.[61]

The procedure for the adoption of DRTS and DITS follows a largely similar path.[62] The ESAs prepare the technical standards in the form of a draft, which require for their adoption a qualified majority by the ESA Board of Supervisors. Prior to the adoption of the draft the ESAs need to conduct public consultations, provide a cost-benefit analysis, and seek the opinion of a stakeholder group specific to each ESA. While making it more transparent and participatory, the danger is that the consultation

[58] As to ESMAs's powers, Schammo, "The European Securities and Markets Authority: Lifting the Veil on the Allocation of Powers", 1883; and Di Noia and Gargantini, "Unleashing the European Securities and Markets Authority: governance and accountability after the ECJ decision on the Short Selling Regulation (Case C-270/12)", 17.

[59] Recital 22 of the ESA Regulations.

[60] Articles 10 and 15 of the ESA Regulations.

[61] Article 10 (1) and (3) of the ESA Regulations.

[62] See Articles 10–14 of the ESA Regulation for DRTS and Article 15 of the ESA Regulations for the DITS.

process is dominated by large corporate actors and sees only a marginal involvement of consumer groups.[63]

The draft is then submitted to the Commission, which in the case of DRTS has to forward it immediately to the European Parliament and the Council. The Commission's endorsement is the essential condition for the draft standards to become binding. If the Commission does not intend to endorse the draft technical standard, to endorse it in part or to endorse it with amendments, it shall send it back to the competent ESA together with an explanation of its objections.[64] Within a period of six weeks, the ESA may amend the draft technical standard and resend it as a formal opinion to the Commission for endorsement. Crucially, the Commission cannot change the content of the draft technical standard without prior coordination with the ESA.[65] If the ESA does not submit an amended standard or has submitted a standard that does not comply with the Commission amendment, the Commission may adopt the standard with the amendments it considers relevant or reject it.[66]

The main differences in the process of the adoption of regulatory and implementing technical standards are the following. First, in case of regulatory technical standards adopted under Article 290 TFEU, the European Parliament or the Council may object to their entry into force within three months from the notification of the DRTS by the Commission.[67] Second, the European Parliament or the Council can revoke the delegation to adopt regulatory technical standards at any time.[68]

The role of the ESAs in the adoption of binding technical standards calls for a number of observations. In relation to the adoption of regula-

[63] Moloney, *EU Securities and Financial Markets Regulation*, 874.

[64] Article 10(1)(6) and Article 15(1)(5) of the ESA Regulations.

[65] Article 10(1)(8) and Article 15(1)(7) of the ESA Regulations.

[66] Article 10(1)(7) and Article 15(1)(6) of the ESA Regulations. For a rejection of a DITS see Commission Decision of 28 January 2014 rejecting the draft implementing technical standards to amend Implementing Regulation (EU) No 1247/2012 laying down implementing technical standards with regard to the format and frequency of trade reports to trade repositories under Regulation (EU) No 648/2012.

[67] See Article 13 of the ESA Regulations. This period can be extended by another three months. The period of objection is, however, just one month in case the Commission endorses the standard, extendable by another month.

[68] See Article 12 of the ESA Regulations.

tory technical standards, it should, firstly, be noted that EU legislation conferring such powers is often quite detailed. This might be the consequence of concerns of the EU legislator about the politically sensitive nature of such legislation, but might also result from the preference to include technical issues on financial services regulation in EU legislation. It certainly seems a move away from the Lamfalussy suggestions of the limitation of level 1 acts to core political principles. Therefore, the powers delegated to the ESAs do not raise concerns in respect to the Court's 'essential elements' doctrine, which seeks to ensure that the important political choices of a subject matter are made by the EU legislator, in particular where they affect fundamental rights and relations with third countries.[69]

Secondly, the process for the adoption of regulatory technical standards and the powers granted to the ESAs raise *Meroni* concerns, even in its more flexible interpretation after the *Short Selling* ruling. Despite the protestations of Union legislation that DRTS 'do not involve policy choices',[70] it should be noted that many enabling provisions in EU financial legislation for the adoption of DRTS are quite broad. They, therefore, allow the ESAs to pursue regulatory options reflecting a difference in reconciliation of competing policy objectives, such as competitiveness of the Union's financial services sector, the protection of financial stability, or the protection of investors.[71] DRTS often reflect a particular choice as to how these competing objectives are reconciled.[72] This is made evident by the cost-benefit analyses that the ESAs have to produce and which are attached to the DRTS.[73] Given the importance of some of the policy choices involved, it is submitted that the endorsement process, which leaves the Commission often very limited room for manoeuvre, may be constitutionally problematic.

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[69] Case C-355/10 *European Parliament v Council*.

[70] See Recital 91 of CRD IV, Recital 27 of CRR, and Recital 22 of Regulation 1093/2010.

[71] See for example Article 124(4) of the CRR.

[72] See for example EBA, "Draft Regulatory Technical Standards on the determination of the overall exposure to a client or a group of connected clients in respect of transactions with underlying assets under Article 390(8) of Regulation (EU) No 575/2013", 20 and 25. Of course EBA has to respect the limits of the enabling provision. Therefore EBA/RTS/2013/10 may be doubtful because it extends the information categories beyond those listed in Article 50(6) of Directive 2013/36.

[73] See EBA, EBA/RTS/2013/07 on large exposures, Sect. 5.1.

Thirdly, the relationship between the ESAs and the Commission questions the Commission's actual decision making power in relation to the final regulatory product. The ESA Regulations provide that the Commission should make amendments only in 'very restricted and extraordinary circumstances'.[74] While the Commission is formally charged with the adoption of regulatory technical standards, the ESA Regulations make it clear that the Commission could amend or reject DRTS only where they were 'incompatible with Union law, did not respect the principle of proportionality or run counter to the fundamental principles of the internal market for financial services (…)'.[75] Moreover, the Commission cannot unilaterally revise the content of the ESA's draft. The ESA Regulations state that '[the] Commission may not change the content of a draft regulatory standard prepared by the Authority without prior coordination with the Authority'.[76] The Commission, therefore, has the choice of endorsing the standard (and thereby surrendering its political prerogative as Union executive while at the same time taking formal legal and political responsibility for it) or objecting (thereby undermining the design for the adoption of such standards). This fragmentation of the Union's executive detaches actual from formal responsibility. Taking into account the institutional design of the ESAs with the Board of Supervisors as *de facto* decision maker composed of national supervisors, the removal of the formulation of the Union interest from the Commission as the constitutionally responsible forum in Article 290 TFEU also seems to undermine democratic legitimacy. The fact that the Commission is represented on the Board of Supervisors, without voting rights, alleviates to some extent its detachment from the actual decision making forum, but obscures further responsibility in the process for the adoption of regulatory technical standards.

In relation to the adoption of DITS, the first issue concerns the distinction between regulatory acts (following the regimen of Article 290 TFEU) and implementing acts (Article 291 TFEU). The distinction is no doubt fraught with difficulty, but needs to be made as a matter of EU

[74] Recital 23 of the ESA Regulations.

[75] Ibid.

[76] Ibid, Articles 10 (1) and 15 (1).

constitutional law. It is, therefore, confusing that the Court in a recent ruling held that 'the EU legislature has discretion when it decides to confer a delegated power on the Commission pursuant to Article 290(1) TFEU or an implementing power pursuant to Article 291(2) TFEU'.[77] Notwithstanding the constitutional importance of the distinction between Article 290 and 291 TFEU, the Court held that it would restrict judicial review 'to manifest errors of assessment as to whether the EU legislature could reasonably have taken the view' that the requirements of Article 291 TFEU were met. Even when account is taken of this softer approach to judicial review, the DRTS/DITS distinction in the recently adopted Union banking legislation is questionable from a legal point of view, as it seems to be based more on the politically sensitive nature of the issues than any reasonable legal considerations. While the adoption of DITS for the format and timing of reporting[78] seems politically uncontroversial, such standards supplement the Union legislation in the same way as other DITS, such as those that are to determine the operational functioning of the colleges of supervisors.[79] The second problem with DITS is that the process for their adoption perverts the premise of Article 291 TFEU, which is based on the Commission adopting implementing acts subject to 'control mechanisms by Member States'. The procedure, to a considerable extent at least, eliminates the deliberative interaction between the Commission and the administrations of the Member States, which characterises the comitology regime.[80] Finally, the same objection as against the DRTS can be made, in that the endorsement process for DITS detaches formal from actual responsibility.

To conclude, the endorsement system is perhaps the most significant element in the limitation of the exercise of discretionary powers attributed to the ESAs to ensure that the *Meroni* doctrine is not bypassed. Yet, as this analysis has shown, the endorsement process provides the Commission only with a negative and exceptional power to discard DRTS and DITS. The existence of strict conditions for the Commission

[77] Case C-427/12, *Commission v European Parliament and Council*, para.40.

[78] See for example Article 101(4) of the CRR.

[79] See Article 116(5) of the CRD IV.

[80] See Türk, "Comitology", 327.

to amend or discard the technical standards shows that the ESAs can play a powerful role in shaping the content of technical standards. In fact, in case the Commission does not reject the draft technical standard, the ESAs may set policy choices that could go beyond the *Meroni*-consistent process where only the delegator is responsible for discretionary choices.[81]

5.3.2 Soft Law Regulatory Tools: The Wide Array of 'Quasi-Hard' Law Powers

The ESAs can adopt soft law measures[82] in the forms of guidelines and/or recommendations addressed to competent national authorities and/or to market players. As stated in Article 16 of the ESA Regulations, this prerogative serves as a way 'to ensure efficient and effective supervisory practices' and 'to ensure the common, uniform and consistent application of Union law'. These acts are subject to certain procedural requirements: open public consultations, they need to be proportionate in relation to their scope, nature and impact, and they must respect cost-benefit concerns.

The ESAs's soft law powers appear to be more stringent than generic soft law powers. The ESA Regulations clearly specify that the addressees shall 'make every effort to comply'[83] with these measures. National competent authorities are obliged to report in a clear and detailed way whether they have complied or intend to comply with the guideline or recommendation. In case the national authorities do not comply or do not intend to comply, they are further obliged to state reasons for non-compliance. The ESAs are entitled to publish the fact of non-compliance and the reasons given by the competent authority following a naming-shaming approach.

[81] See also, Busuioc, "Rule Making by the European Financial Supervisory authorities: walking a tight rope", 117.

[82] On the definition of soft law in the EU legal order see the extensive study of Senden, *Soft Law in European Community law*, where the author defines in Chap. 8 soft law as 'rules of conduct that are laid down in instruments which have not been attributed legally binding force as such, but nevertheless may have certain (indirect) legal effects, and that are aimed at and may produce practical effects'.

[83] See Article 16(3) of the ESA Regulations.

Therefore, peer pressure and disclosure of information to other parties is a system of enforcement with a view to compliance.

It is worth noting that guidelines and recommendations are only one element of 'soft law' regulatory tools at the disposal of the ESAs. A wide array of tools also include the development of the supervisory handbook, systemic risk tools, peer review processes, information management and reporting tools, methodological tools, and warnings.

Against this background, it is important to analyse further the power of adoption of soft-law measures by the ESAs. For instance, the Capital Requirements Regulation (CRR) and the Capital Requirements Directive (CRD) IV extensively confer the power to adopt guidelines to the EBA, often with reference to Article 16 of the EBA Regulations, but not always.[84] Article 16 of the ESA Regulations may, therefore, constitute a general enabling provision for the adoption of guidelines (irrespective of whether a specific legislative provision exists), given that, in contrast to Articles 10 and 15 of the ESA Regulations, no reference is made to powers conferred in acts mentioned in Article 1 paragraph 2 of the ESA Regulations. It is also interesting to note that a survey of Union legislation enabling the EBA to adopt guidelines reveals a vast amount of different types of such guidelines. One can distinguish between practice enhancing guidelines, methodology guidelines, benchmark-setting guidelines, implementation/application guidelines, and interpretative guidelines. In particular, implementation guidelines are often indistinguishable in content from regulatory technical standards.[85] Furthermore, in practice many technical standards that have recently been adopted have as their basis CEBS guidelines and certain legislative provisions make guidelines expressly a precursor to the adoption of technical standards.[86]

Given their practical importance as quasi-technical standards, it is important to consider the effects of such guidelines, not only in light of Article 16, but also in light of the wider constitutional principles set out above. It is submitted that no conferral issues arise, provided such guidelines do not impose legal obligations of their own. The only binding legal effects of guidelines are those set out in Article 16, which do

[84] See for example Article 74(3) of the CRD IV.

[85] Ibid.

[86] See Articles 243(6) and 244(6) of the CRD IV.

not, however, compel the national authority to follow the guidelines, but do impose an obligation to state reasons. Hence, ESAs's soft law powers might act as *de facto* hard law powers as they produce legal effects which can go beyond the non-binding force of these acts. This view is based on the *Grimaldi* ruling, in which the Court did not exclude that soft law powers might still have legal effects, in that they have to be considered by national courts in deciding national disputes.[87] In particular, it has been argued that the public instances of 'naming and shaming' act as an element to ensure enforcement.[88] However, the indirect legal effects of soft law powers raise concerns of accountability and legal certainty.[89]

Therefore, even without apparent legally binding effect, ESA guidelines can have indirect legal effects. Such effects could arise in particular in relation to Articles 17 (breach of Union law) and 19 (mediation) of the ESA Regulations. While guidelines do not constitute a body of hard law, the breach of which could trigger the application of Article 17, it is possible to envisage a situation in which the ESA in its interpretation of Union law (including DRTS and DITS) relies on one of its guidelines.[90] In such a case, the guideline, while not binding on the competent authority, will have a prejudicial effect as to the outcome of the case, while any final decision on the correct interpretation of Union law rests with the Court. It should, however, be made clear that a guideline cannot, in and of itself, impose directly applicable requirements in the sense of Article 17 paragraph 6 of the ESA Regulations. Conversely, however, guidelines bind the ESAs in the exercise of their powers under Article 17. Where the ESAs have published guidelines, the ECB, national authorities and financial institutions should be entitled to rely on the guidelines. While the ESAs can amend those guidelines for the future, the principle of legitimate expectations would, in principle, preclude any deviation in a single case decision (such as Article 17).

[87] Case C-322/88, *Grimaldi*.

[88] Busuioc, "Rule Making by the European Financial Supervisory authorities: walking a tight rope", 118.

[89] Tridimas, "Financial Supervision and Agency Power: Reflections on ESMA", 72.

[90] It is, however, clear from the recent ruling in Case T-660/14, *SV Capital OÜ v EBA*, paras. 66 to 72, that Article 17 of the ESA Regulations can only be employed in case of non-application or a breach of Union law set out in Article 1(2) of the ESA Regulations, as well as any DRTS and DITS.

As regards Article 19 of the ESA Regulations, it is submitted that also in this case guidelines cannot form part of the body of Union law, compliance with which ESAs may ensure against national authorities or financial institutions.[91] Even if the *Short Selling* judgment of the Court has somewhat alleviated the constitutionally precarious nature of Article 17 and Article 19 of the ESA Regulations, it is not entirely clear why the power granted to the ESAs should not lie with the Commission according to Article 291 TFEU. This raises concerns about the institutional balance and democratic legitimacy.

Finally, some specific mention should be made of other soft law measures such as the European supervisory handbook that, as a collection of supervisory practices, plays a fundamental role for soft law regulation in financial markets. In fact, such tool has the potential to harmonise supervisory practices in the EU. This may happen in two ways. First, in the short term it can enhance supervisory practice. Nevertheless, while being a valuable tool for the ECB and national authorities, the concerns here are the same as for guidelines. Second, in the long term its provisions will no doubt act as precursors to guidelines, technical standards, and even legislative provisions. The issue will be to identify which provisions should be included in legal rules and which should best be left to informal practices. A trend towards more legislation is not necessarily always the best option. Furthermore, on the path from supervisory handbook practice through guideline to technical standard, the issue of political judgment and the importance of process values might become relevant.

5.3.3 The ESAs' Market Control and Supervision Powers

ESAs have a range of market control and supervisory powers over market operators and national supervisors. One of the essential powers of ESAs is to ensure the consistent application of EU rules. Article 17 of the ESA Regulations allows the ESAs to have recourse to a structured enforcement procedure, which is similar to the general enforcement pro-

[91] See ESA Regulations, Article 19 paragraphs 3 and 4.

cedure under Article 258 TFEU. The procedure is divided into different phases that resemble the procedures under Article 258 TFEU. In the first phase, the procedure provides for an investigative formal phase where the competent ESA carries out an investigation upon its initiative[92] or upon the request of an institution or a competent authority. The competent authority against which the investigation is carried out has the obligation to provide the ESA with all the information that it considers necessary for the investigation. The power of investigation concerns the application of banking, securities and occupational pension scheme law or the regulatory and implementing technical standards adopted by the ESA. During the second phase, the competent ESA will, no later than two months from the initiation of the procedure, address recommendations to the competent authority with a view to setting out the necessary action to comply with EU law. This phase can result in an informal agreement between the acting parties, which would avoid the issuance of the formal recommendation by the competent ESA. The third phase includes the participation of the Commission. In case the competent authority has not followed the ESA's recommendations, the Commission will be involved in the process and may issue a formal opinion to the competent authority.

From a critical point of view, it appears that the Commission's opinion is the central element of the procedure, without which the enforcement of EU law cannot be pursued. In case a competent authority does not comply with the formal opinion of the Commission, the ESA, 'where it is necessary to remedy in a timely manner such non-compliance in order to maintain or restore neutral conditions of competition in the market

[92] The position of the Board of Appeal has been that, while the ESAs have discretion as to whether to investigate breaches of Union law by competent authorities on request by a private party, they must nevertheless exercise this discretion properly. See ESA Board of Appeal, Decision of the Board of Appeal of 24 June 2013, *SV Capital OÜ v EBA*, para.34; ESA Board of Appeal, Decision of the Board of Appeal of 14 July 2014, *SV Capital OÜ v EBA*. This view has, however, not been shared by the General Court which, in Case T-660/14, *SV Capital OÜ v EBA*, paras. 48 and 49, ruled that the lack of procedural rights in the investigation procedure means that they cannot challenge a decision by the EBA not to investigate an alleged breach by a competent authority. It is similarly clear from that judgment, in particular in paras. 64–72, that the Board of Appeal cannot review a rejection by an ESA of a request by a private party to employ its power under Article 17 of the ESA Regulation.

or ensure the orderly functioning and integrity of the financial system',[93] is empowered to adopt decisions with binding effect for financial institutions to ensure compliance with directly applicable Union legislation.

The ESA Regulations also provide in Article 18 for a system of intervention powers in emergency situations. These powers are triggered in the case of adverse developments which may seriously jeopardise the orderly functioning and the integrity of the whole or part of the financial system. The ESAs must actively facilitate and coordinate actions undertaken by the relevant competent supervisory authorities. Any formal decisions of the ESAs are, however, dependent on a formal decision by the Council as to the existence of an emergency situation. It appears that discretion is only partial and the Council's formal emergency decision forms the essential boundary of the exercise of emergency powers by the ESAs.[94] Where the relevant competent authority fails to address the ESAs's decision, the ESA can adopt an individual decision addressed also to market actors, including the cessation of any practice.

The arrangements contained in Articles 17 and 18 of the ESA Regulations show that the process of adoption of individual decisions has been the object of extensive negotiations.[95] The result appears as a 'patchwork' procedure where the EU legislator has strived for a sound institutional balance.

Further, the ESAs's Regulations contain provisions for the settlement of disagreements between national supervisory authorities.[96] The role of the ESAs in this case is threefold as they are mediator, decision-maker and enforcer. When competent authorities disagree on the procedure or the content of an action or inaction of a competent authority of another member state, the ESAs may be called upon to settle the disagreement. The ESAs can intervene at the request of one or more of the competent authorities or on their own motion. The system to settle disagreements could play an important role, even more than the enforcement actions discussed earlier. The role of the ESAs in this case is stronger than in the

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[93] Article 17(6) of the ESA Regulations.

[94] Tridimas, "Financial Supervision and Agency Power: Reflections on ESMA", 76.

[95] See Moloney, *EU Securities and Financial Markets Regulation*, 882–884.

[96] ESA Regulations, Article 19.

enforcement procedure as no reference is made to the Commission. It is submitted that this situation makes the ESAs more powerful than what would appear acceptable under the *Meroni* doctrine, as the ESAs can use some discretion in evaluating the disagreement between competent authorities.[97]

Nonetheless, in the context of these powers, the safeguard for the fiscal responsibilities of the Member States constitutes a strong limitation for the ESAs. This provides that the ESAs's decisions adopted on the basis of Articles 18 and 19 shall not impinge on the fiscal responsibilities of the Member States.[98] This gives ground to Member States to contest the validity of an ESA's decision if this impinges on national fiscal responsibilities. It appears that this safeguard provision expresses the limited powers that the ESAs can have in practice *vis-à-vis* national authorities as it acts as an *ex post* form of control to the adoption of the ESAs decisions under Articles 18 and 19.

5.4 Concluding Remarks

The establishment of the ESAs constitutes an important development in the current process of 'agencification' in the EU financial markets. It appears that the ESAs have initiated a new and peculiar wave in agency design. The ESAs enjoy an extensive degree of autonomy, even if some aspects remain under the scrutiny of the EU legislator and the Commission. The ESAs have been given stronger powers for Union administrative rule-making, as well as the supervision and control of national competent authorities and market participants than the pre-existing Lamfalussy level 3 committees. Even though ESAs are composed of members of the national regulatory authorities and their hard law reg-

[97] See, however, the reference in Article 19(3) of the ESA Regulations to the use of the power to ensure 'compliance with Union law' indicating a mere 'legality' review of competent authorities. However, a wider reading of the scope of Article 19 can be justified on the ground that Article 19, as a procedure, in addition to Article 17 would otherwise be superfluous.

[98] See Article 38 of the ESA Regulations. The omission of Article 17 in Article 38 provides a further argument for a wider reading of the scope of Article 19.

ulatory powers require the endorsement by the Commission, they enjoy a wide margin of manoeuvre to shape EU financial regulation.

As shown in the previous sections of this chapter, the ESAs's role in the Union's constitutional framework and the degree of their regulatory and supervisory tools is open to some criticism. First, it is doubtful whether the *Meroni* doctrine, even in its more flexible form after the *Short Selling* ruling, is still a real parameter to assess their vast array of regulatory powers. The institutional arrangements, safeguard measures and limited scope of intervention require some reinforcement to ensure that the ESAs do not enjoy purely discretionary powers and that the institutional balance in EU financial regulation and supervision is respected.[99] It appears that further clarification on the reach of the *Meroni* doctrine by the Court is required in this respect. More profoundly, however, it is questionable whether their important role in the regulation of financial markets will ultimately have to go beyond the confines of the *Meroni* doctrine.

Second, the real use of Article 114 TFEU appears blurred as the ESAs perform tasks, which, undeniably, may go beyond the boundaries of the harmonisation of the internal market.

Third, it is unclear what the relationship is between the ESAs and the Commission within the ESFS. The ESA Regulations suggest that the ESFS is an 'integrated network system of national and Union supervisory authorities'. However, after five years it is still somewhat obscure what the real balance of power between the ESAs and the Commission within this system is. Do ESAs have 'real teeth' to contrast or to counteract the Commission or do they heavily depend on it? The existing ESAs's decision making structure indicates that the Commission shall bear the final responsibility to adopt technical standards in the form of EU legally binding acts, but that the ESAs determine their content.

Fourth, the establishment of the EBU and its two pillars, the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM), have opened a new era for European financial integration. The arrangements to establish the SSM and the SRM appear problematic for

[99] See similarly Chiti, "In the Aftermath of the Crisis: The EU Administrative System between Impediments and Momentum", 5.

the ESAs, and in particular for the EBA.[100] What will the EBA's role be in supervising European banks? Will it be more and more ancillary to the leading role that the ECB plays in the Eurozone? The new EBU reform arrangements show that the EBA has been partially delegitimized in its role as the player of supervisory convergence in Europe to the benefit of the ECB. Is this a satisfactory solution? The existence of a centralized supervisor in the SSM might prove a challenge to the supervisory convergence role played by the ESAs in the internal market.

Before the outbreak of the financial crisis, it was unimaginable that the Lamfalussy level 3 committee structure could perform tasks similar to the ones conferred on ESAs. The creation of ESAs has been a welcome development in the institutional architecture of EU financial regulation. However, the constitutional constraints and challenges outlined in this chapter show that improvements need to be made to the current institutional and regulatory role of the ESAs. The 2014 ESFS Review Communication[101] did not show particular interest or momentum in further strengthening of the role, scope and powers of the ESAs, but concentrated more on stock-taking and on concerns regarding the relationship of the ESFS with the EBU.

Notwithstanding such limited appetite for imminent reforms, the ESAs appear to be an important institutional development towards financial integration and convergence in the Union and a sensible, if often constitutionally challenging, answer to the lack of adequate regulation and supervision of the European financial markets.

[100] See Moloney, "Banking Union and the implications for financial governance in the EU: convergence or divergence?", 524.

[101] European Commission, *Report from the Commission to the European Parliament and the Council on the Operation of the ESAs and the ESFS*, (2014).

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Part II

A View from the Periphery

6

Class and Politics in the Greek Debt Crisis

Vassilis K. Fouskas and Constantine Dimoulas

6.1 Introduction

From at least 2009 onwards, successive Greek governments, including the left radical government of Syriza (Coalition of the Radical Left) accepted a humiliating process of negotiation with, and subordination to, their foreign creditors in order to maintain the country in the Economic and Monetary Union (EMU) at all costs. The terms of the bailout agreements, three in total, were even more humiliating. Although it falls outside the scope of this chapter to examine them in detail, it is worth mentioning their key pillars. First, they passed on to the public institutions the biggest part of the debt so that the Greek taxpayer will have to foot the bill via an unprecedented set of austerity measures which, over the last five years, caused social havoc: 26 % loss of GDP, massive unemployment and a further increase in

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L.S. Talani (ed.), *Europe in Crisis*,
DOI 10.1057/978-1-137-57707-8_6

the debt to GDP ratio (from 118 % in 2010 to 178 % today). Second, they subjugated key departments of the Greek state to a number of European committees and assessors, which directly control the policy management structures of most Ministries. Elsewhere, such as in Eastern Europe and the Balkans, this is justified via the official process of the 'European Semester' mechanism led by the Commission, which oversees the budgets of all current and future EU member states. But there are also important details we do not know. One such detail was revealed by the former Greek Minister of Finance, Yanis Varoufakis. While trying to test his 'Plan B' back in May-June 2015 in case negotiations with the creditors failed, he was surprised to find out that even the General Secretariat for the Public Revenue based in his Ministry was controlled by the creditors (Varoufakis 2015). Thus, his contingency plans could not come to fruition.

All Greek governments had to turn the bailout agreements into State Law via an authoritarian parliamentary process of decree issuing and scaremongering; the agreements themselves are against the letter and spirit of the Greek Constitution (Pavlopoulos 2011). To all intents and purposes, the EU, under the hegemony of its key creditor and industrial power, Germany, and the tutelage of global banking and financial institutions, is evolving into a neo-colonial regime of formal control and expansion promoting authoritarianism instead of democracy and solidarity in order to satisfy the monetarist and neo-mercantilist requirements that are at the core of the EMU discipline as a monetary regime.

As the bailout agreements transferred onto the taxpayer the burden of Greece's debt obligations, an ideology should be put in place to justify austerity. It has thus been argued that the Greek (and Eurozone) crisis is a fiscal crisis that emanated partly from the incompetence of the Greek (and other peripheral EU) state(s) to collect taxes, partly from their own states' profligacy with a huge and uneconomic public sector, and partly from the 'fact' that these societies are not working as hard as their protestant northern neighbours. This ideology has been defeated by original work carried out in the past few years not only by Marxisant scholars and heterodox economists, but also by important financial commentators and journalists, such as Martin Wolf of the *Financial Times* (Wolf 2012, 2013). The Eurozone crisis, this winning approach argued, is a balance of payments crisis that is bound up with Germany's anti-inflationary, low

wage, export-led growth creating permanent surpluses for herself and permanent deficits for the periphery. At a more theoretical, yet substantive, level, the Eurozone crisis pertains to the uneven historical developmental structures of European economies, which are creating and reproducing a number of economic and political disequilibria across the EU and EMU, undermining convergence and promoting disintegration.

This chapter aims at advancing these debates further. By offering a historical reading of Greece's social and political economy from the 1990s onwards, it brings into context agential aspects of the story hitherto unexamined, that is, it advances a class analysis of the Greek crisis. The thesis put forward is that Greece's dominant capitalist class has always been a comprador, one which from the early 1990s onwards began diversifying its main activities following the global trends of financialisation, European monetary integration and, eventually, the insertion of Greece into the EMU in 2001. It is argued that this class constitutes the most parasitic and corrupt element of Greek society and politics and that it is the transnational and subordinate connections of this class, together with its political representatives, that are chiefly responsible for the creation of the debt and how it was managed politically.

We will first deal with the global context of the problem and the issue of the 'power-shift' to Asia. Then we will concentrate on the class origins of the Greek debt crisis by way of combining historical and contemporary perspectives, thus viewing it as a symptom of global structural forces and shifts. It will transpire that Greece was used by the West as a platform to advance neo-liberal financialisation in the Balkans and the Near East and that the so-called 'growth years' of 2000–2006 were, like everywhere else in the West, comprehensively debt-driven.

6.2 The Global Context and the Issue of Neo-Liberal Financialisation

Arguably, the provenance of the financial crisis which hit the Anglo-Saxon economies in summer 2007 can be traced back to the 1970s. This was the decade of two oil-shocks, *stagflation* and the collapse of profitability in the real economic sector and, fundamentally, President Nixon's

decision to get rid of the Gold fetter (Gowan 1999; Brenner 2003). The end of the Gold-Dollar parity and of fixed exchange rates unleashed *financialisation* in historically unprecedented ways (Glyn 2007; Aglietta 2008; Fine 2010; Duncan 2012): credit and financial flows expanded exponentially, a process that was accompanied by massive growth in the volume of global trade and Foreign Direct Investment (FDI), including portfolio investment, asset management activity, mergers and acquisitions and extreme speculation in currency and derivatives markets. Oil trade has been peculiarly dollarised (Fouskas and Gökay 2005). What is hiding behind the term 'globalisation' is in fact a process of extreme financialisation, that is, activity of unfettered and uncommitted capital, capital that is not conducive to real commodity production (Fouskas and Dimoulas 2013; Wolfson and Epstein 2013) and sustainable economic development. In the indebted West today, the real economic sector has receded, giving way to fictitious capital activity, speculative arbitrage, services and consumption, all of which are prone to boom and bust cycles, vast consumer indebtedness and extreme volatility and risk. Financial capital and generalised indebtedness have permeated the daily life of Western citizenship. Financialisation is the first monumental transformation that occurred in the Organisation of Economic Cooperation and Development (OECD) economies in the wake of the collapse of the Bretton Woods system in the late 1960s. This transformation was led by the United States of America (USA).

The second massive transformation of social and political relations, the sister-tendency of US-led financialisation, goes under the name of *neo-liberalism*. This term primarily applies to the domestic environment of the state. For some, overcoming *stagflation* and the fiscal crisis of the state in the 1970s entailed the following: the welfare state must be retrenched; labour markets, banks and finance should be deregulated and state enterprises should be privatised. By 'deregulation' is meant moving those agencies from state to private ownership and, in the case of labour unions, freeing them from state protection. This did not mean an end of state interference, inasmuch as the neo-liberal capitalist state has moved to 'regulation via legislation' and coercion (Sassoon 1996; Panitch and Gindin 2012). Neo-liberal regimes of financial accumulation are almost entirely based on a set of complex regulations advanced by the legislative

branch of the bourgeois state (Lapavitsas 2013), whereas class resistance to them is met with state coercion and policing. In this context, by the early 1980s, governing elites, whether on the Left or the Right, abandoned Keynesianism, giving way to supply-side economics.

Essentially, neo-liberalism *and* financialisation were the responses of the West to the profitability crisis in the 1970s. Yet the failure of this strategy to restore profitability and growth rates has been spectacular; in addition, it has failed to arrest the slow and protracted decline of the Western core as a whole. This slow decline of the core goes hand in glove with the complex—and debatable for some scholars—ascendance of China and other emerging economies, especially after the end of the Cold War. China dominates the world market in rare earth elements (a class of minerals that are essential for electronics and computers) and has become the second largest economy in the world—it overtook Japan in February 2011. China has become the engine driving the recovery of other Asian economies from the recessions of the 1990s. In September 2013, the British Chancellor of the Exchequer, George Osborne, rolled out the red carpet for Chinese banks looking to expand in London, making the city a significant Chinese offshore banking centre. China has already captured a large share of Africa's oil and minerals market and dominates the textiles industry in Latin America. China and India produce a combined total of more than half a million engineering and science graduates per year. The respective numbers for the USA is 60,000. Although financialised and integrated into a global economy in which the dollar remains the key reserve currency, the real economic output of the so-called BRICS (Brazil, Russia, India, China, and South Africe) is healthy and their debt levels very low (Fouskas and Dimoulas 2013, 136). Financialisation increased the global debt in the time span of a decade (2002–2012) in every country except China, India, Brazil, Russia and South Africa. But where does Europe figure in all this?

During the 'Golden Age of Capitalism' of the 1950s and 1960s (Hobsbawm 1995), Germany reasserted itself as Europe's economic powerhouse. As Robert Brenner and others have argued, it was mainly competition from German and Japanese capitals that drove the downward spiral of the rate of profit in the Anglo-Saxon world (Brenner 2006;

Busch 1976). Germany drove the process of European integration outflanking France, something which was pointed out already in the late 1960s by such scholars as Nicos Poulantzas and Christian Palloix in France, and Elmar Altvater in West Germany (Poulantzas 1974; Palloix 1975). Soon, however, problems appeared. How to reconcile the tension between 'deepening' and 'widening', in other words, pushing for more capitalist integration in the direction of a (federal) United States of Europe, and enlarging in consecutive steps (from 6 countries in 1957 to 27 countries in 2010)? How could the pronounced developmental gap between the core and the periphery be bridged? With a customs union at hand since the Treaty of Rome, and prompted by the monetary instability of the late 1960s, the Europeans pushed for monetary integration with the Werner Report of 1970. It came to naught due to American pressure, yet many in Europe at the time believed that Europe's economic space represented an 'optimal currency area'—as Robert Mundell put it in a celebrated article in 1961—an ideal regional economy almost perfect for monetary integration (Mundell 1961). This indeed was the view that more or less dominated Europe's policy making establishment until the breakout of the current crisis. Their concern was to eliminate currency crises, exchange rate instability and risk.

This is the first fallacy, namely that uneven and deeply asymmetrical levels of economic development across Europe could be bridged by putting all currencies into the same hat and then, miraculously, levelling out uneven development and structural fault lines by pulling the rabbit out of the hat—the euro, a currency lacking the political and fiscal support of a state. The second fallacy is called financialisation. From the 1980s onwards the dominant forces behind the processes of 'deepening' and 'widening' were other than Keynesian; they were deeply pro-monetarist, mercantilist forces, as if Europe had been 'Hayek-jacked'. The emphasis, also because of pressure from Britain and the USA, was on 'widening' rather than 'deepening'. Neo-liberalism and financialisation suited Germany very well, but one should not confuse the German model with the Anglo-Saxon one. German banks do not operate in the same way as British or American banks (Lapavitsas 2013). The Anglo-American model is driven by consumption and debt; the German model by an anti-

inflationary, export-led growth regime. These differences are very significant. From the Single European Act of 1986 to the Maastricht Treaty of 1991, and from the Growth and Stability Pact of 1997 to the launch of the euro in 1999 and after, the process of European integration has been subjected to a neo-mercantilist bias emanating from a relentless German strategy of export-led growth and wage suppression. The monetarist character of the Maastricht criteria was the result of this type of German discipline. From the mid-1990s onwards, and in order to increase profitability and price competitiveness, Germany put enormous downward pressure on wages (Stockhammer 2013).

Low wages, coupled with the institutional capacity of the German state and the dynamism of its real economic sector, magnified the existing gap between core and periphery. As we shall see, the introduction of the EMU in 1999 exacerbated the asymmetries and monetary imbalances across Europe. Thus, when the global financial crisis trickled down to the Eurozone via the banking sector—German and European banks had bought 40 % of American CDOs (Collateralised Debt Obligations) and other toxic assets—the disintegrative tendencies of the EU multiplied overnight. Greece has been and remains the weak link in Europe's and the world's financialisation chain.

6.3 Three Views on the Greek Crisis

The most authoritative view that considers the external environment of the peripheral/debtor state as the main cause of the debt crisis in Europe comes from Martin Wolf. In a lecture he gave in London on 3 October, 2012, the chief economics commentator of the *Financial Times* argued:

> This is not, in its origin, a fiscal crisis, but a balance of payments *cum* financial crisis. In the run up to the crisis, there were huge internal capital flows. These opened up current account imbalances and generated huge divergences in competitiveness. After 2008, cross-border private financial flows suffered a series of 'sudden stops'. These caused, or aggravated, a fiscal crisis. (Wolf 2012)

An almost identical thesis was advanced by Costas Lapavitsas et al., at least as far as the origins of the crisis was concerned: 'The crisis', it is argued in a Report produced by the group Research on Money and Finance based at School of Oriental and African Studies (SOAS), University of London, 'is not due to fiscal profligacy (…). Its roots lie in the loss of competitiveness by the periphery coupled with an enormous financial expansion in the 2000s' (Lapavitsas et al. 2010, 2011). Germany, due to its suppression of wages, became far more competitive than any other European country, a fact that enabled it to recycle its financial surpluses across Europe rendering especially the periphery and Greece with huge financial account surpluses. In short, this tendency sees the crisis emanating from the financial sector, which facilitated borrowing for the periphery via low interest rates, especially in the 1990s and early 2000s. But when this came to an end from the mid-2000s onwards, and especially with the onset of the financial crisis in summer 2007, the equilibrium was destroyed. With the global financial crisis setting in, rising interest rates exposed the public and private sectors, which were now in possession of large amounts of bad securitised paper/debt that belonged to the periphery. Lapavitsas, in addition, goes as far as to argue that the EMU has created a split between core and periphery, creating discriminatory and hierarchical relations between the two. The cure, in this respect, is a debtor-led default and exit from the Eurozone, imposition of exchange controls followed by a new industrial policy and the introduction of a new national currency. As far as the banking sector is concerned, it should be nationalised. This Left strategy would have the additional benefit of breaking the yoke of austerity in the rest of Europe, especially Germany, which would be forced to boost aggregate demand and rise wages in order to boost domestic consumption.

These analyses make a lot of sense, especially from a 'structuralist' point of view. Technically, there is no doubt that the debt crisis in the periphery was triggered from outside the periphery states. But this was only the trigger, for the underlying causes are much more diverse and complex. The thesis is vulnerable especially when we bring into the picture agency and history. As we have seen, the split between core and periphery in

Europe has not been caused by the introduction of the EMU. Core–periphery relations are enshrined in the structural and historical reproduction of capitalism as a global social system and pertain to Greece's peculiar form of dependency and subordination upon the core. Greece and other periphery countries in Europe and the world do not need to participate in any monetary union whose usurious and imperial effects would be to lead them to bankruptcy and default. Greece has defaulted several times in its history and has constantly been in a debt spiral without participating in any currency union—indeed, having its currency pegged to an imperial currency was good enough to trigger bankruptcy given the vulnerability and weaknesses of the country's productive and technological sectors (Fouskas and Dimoulas 2013). Most likely, it would have defaulted on its debt obligations even without participating in the EMU since 2001, and it could have defaulted earlier, in the late 1980s or early 1990s, had it not been for the challenges created on its northern borders by the collapse of the Soviet Union (NATO's and EU's eastward expansion, oil and gas pipeline projects, projection of financialisation into the Balkans and so on). Both financialisation and the collapse of 'really existing socialism' on its northern borders had simply given Greece another fifteen years lease on life. Bankruptcy would have happened anyway, with or without participation in the EMU. In the end, the forms of dependency and subordination of Greece are not just economic—they are also political.

The second tendency in the recent literature on Greece sees the fiscal component of the state as the main culprit for generating the unprecedented debt crisis of 2010–2013. The focus here is on the institutional weakness of the Greek state, its fiscal malaise and inability to enforce tax collecting mechanisms, the issue of political clientelism and so on. As two representatives of this tendency put it:

> The capacity of the Greek economy to exercise effective counter-cyclical expansion has been fatally undermined by its chronic inability to exercise fiscal discipline when the economy was still expanding (…) The inadequate progress in improving long-term fiscal sustainability is demonstrated in a public debt to GDP ratio (…) Excessive public indebtedness reflects diachronic weaknesses including inefficient public administrative and bud-

> getary structures, inadequate collection of revenues and tax evasion, high defence spending, and a tradition of clientelistic appointments in the public sector. (Pagoulatos and Triantopoulos 2009)

Other similar views come from assessors and researchers from the Economic Research Department (ERD) of the Bank of Greece, experts and assessors of the European Central Bank (ECB), and think-tanks around the Directorate-General for Economic and Financial Affairs of the European Commission:

> (…) Deep-seated problems in the Greek economy remained unaddressed, reflecting a pro-cyclical fiscal policy; as a result, the country continued to run large fiscal and external deficits (…) The widening of the deficits was mainly expenditure-driven (…) The large and widening fiscal deficits contributed to growing current-account deficits (…) In the case of Greece, the widening of the current account deficit was caused entirely by the behaviour of the public sector. (Dellas and Tavlas 2012)

It is interesting here to note how this tendency minimises the external dimension of the crisis (low interest rates and high borrowing, current account imbalances, financial flows etc.) in order to attribute to the state primary responsibility for causing the Greek debt problem. The second extract, in particular, considers the current account deficit as driven entirely by the state, a thesis which is rather flippant. As one of the two main expressions of the balance of payments—the other being 'capital/financial account'—current account does straddle the domestic and external environments of the state, the determining factor being the social productive basis of the state. Germany was in a position to recycle its financial surpluses which were constantly entering and exiting the periphery states' accounts proliferating their debt ratio, precisely because it had the strongest industrial/institutional structure in the Eurozone. The aspect of social relations of production is wholly ignored by this tendency and together the real interaction between the domestic and external sources of debt creation. The solution proposed by this tendency is close to that of the troika: strict anti-inflationary policies, harsh austerity measures, cutting down the size of the public sector, complete welfare

state retrenchment with the aim being the creation of primary surpluses in order to serve debt repayments.

The third tendency, around which a number of European economists, neo-Marxists and various left Europeanists converge, is that the European project has been deficient from its birth and the real problem is ‘neither Greece nor Germany but the system of the Euro’ (Milios and Sotiropoulos 2010). Despite the variations and tensions within this current, they all seem to accept that the real cause of the crisis lies at the heart of the European project, which also becomes the privileged terrain of political struggle for overcoming the crisis. In this respect, one of the most interesting and progressive approaches comes from John Milios and the group around the journal *Thesseis* (‘Positions’) based in Greece.

Following Leo Panitch’s analyses, Milios et al. argue that neo-liberal globalisation has not only solved the problem of capitalist profitability which dominated the *stagflation* period, but also facilitated real economic convergence between centre and ‘periphery’, especially within the Eurozone (Lapatsioras et al. 2009). This can be seen from the high rates of growth and profitability in the ‘periphery’—Milios et al. do not accept ‘world systems and dependency’ theories, hence their usage of inverted commas for the term ‘periphery’—ten years before the crisis and the large financial surpluses circulating in Greece and other ‘periphery’ states. In fact, it was the high rates of development in the ‘periphery’ which ‘attracted savings’ from the ‘centre’, financing increased demand. This view was first formulated in 1990 and argues that Greece’s current account deficit is sustainable to the extent that the conditions of profitability for capital are good and Greece attracts foreign investments and invisible earnings (e.g., emigrants’ remittances) (Milios and Ioakimoglou 1990). The authors assumed that the conditions that prevailed in the 1960s will continue to be the same, now under the aegis of German capital:

> The perspective of Common European Market (…) is expected to boost the inflow of foreign (investment) capital in Greece to such a degree that: (a) it will boost the penetration of foreign commodities in the Greek market and (b) it will be accompanied by a corresponding augmentation of the

> marginal efficiency of concrete domestic business units and branches. (Milios and Ioakimoglou 1990, 172)

On the basis of this assessment, this tendency argues that Germany's 'economic locomotive' in Europe would bring about positive results for the Greek economy in the 1990s, whereas European capitalism as a whole does not generate internal tendencies of disintegration of its exchange rate system. This view proved to be shortsighted, for the authors completely disregarded uneven development and the fact that the growth registered was unsustainable and artificial because it was debt-driven. As we shall show, the 'German economic locomotive' and the EMU contributed to the further disintegration of Greece's and the European periphery's productive base. In the end, this tendency illustrates that 'financial account surpluses in the periphery are responsible for the ballooning of current account deficits' (Milios and Sotiropoulos 2010, 230). It is herein, moreover, that lies the innate deficiency and contradiction of the Euro-project:

> On the one hand, the symbiosis within the Euro-zone has until now been built upon persistent financial account imbalances mostly due to different rates of growth and profitability. On the other hand, without the latter it would be difficult for the Euro-zone to exist, because it is at the same time a way of offsetting the pressures imposed upon labour. (Milios and Sotiropoulos 2010, 236)

But this argument is circular because the 'surplus' which is enshrined in the structure of financial (capital) account is in fact a form of debt with claims on the assets and individuals of peripheral countries. As we shall try to show, financial surpluses circulating in Greece and the periphery were not going into investment projects and the real economy, but into consumption and easy profiteering via the banking system. Interestingly, this is the view adopted by the ruling group of Syriza, which elaborated a strategy of negotiating the debt problem of the country within the EMU, a strategy that failed miserably in February–July 2015, the result being the breaking up of the party and the call for a new election on 20 September, 2015.

Obviously, the approaches we have just reviewed are but a fraction of the growing scholarly literature on the subject of Greece/Eurozone debt crisis. However, they are indicative of what dominates the current scholarly debates, thus offering readers the necessary yardstick to assess our own analyses. Our main concern is to identify the causes of the current crisis and the agencies driving it. Looking at the structural/technical parameters of the crisis as economists usually do is not good enough: (class) agency, history and comparison hold the keys to a holistic understanding of our subject matter, and indeed every subject matter at least in the field of social sciences.

6.4 Stock Exchange Bonanza and Banks

Greece did not simply have a problematic structure of public debt that appeared in the 1980s, something which was also true in the case of Italy, Belgium and other countries at the time. Greece had also tried to resist neo-liberalism and financialisation, but all the while lacking robust export-orientated sectors to buttress sustainable levels of development, thus matching the rising trend of its debt structure and the borrowing requirement (Fouskas 1997; Fouskas and Dimoulas 2013). As Greece was moving out of the domain of Keynesian policy and entering the structures of neo-liberalism in the 1990s, a new policy framework of speculative and rentier activities became entrenched, contributing to making even more problematic, unsustainable and unmanageable the domestic structures of debt by the ruling parties of Panhellenic Socialist Momement (PASOK) and New Democracy (ND). The comprador element in the Greek social formation is the key to grasping the origins of the crisis as an articulation of domestic and external factors in the generation and mismanagement of the debt problem.

In the beginning it was asset capitalisation, equity and profits through the share price index in the Athens Stock Exchange (ASE). The bubble of the ASE was largely buttressed by privatisations and the underground economy, as those positioning themselves in the ASE and buying and selling shares were not required to prove their income status, or where their

income came from. The bubble burst in September 1999, never to reach that level again (Table 6.1). As elsewhere in the West, the result of this speculative boom and bust cycle was to circulate paper assets and liquidity away from production, while concentrating wealth in the hands of a very few speculators who 'cashed out and got out', switching the focus of their speculative activities elsewhere, mainly abroad. The loser, as usual, was the small investor—some 10 % of Greeks had bought shares on the stock market, an apotheosis of Greek 'popular capitalism', what Tony Blair in the late 1990s used to call the 'stakeholder society', the pillar of his 'Third Way'. European funds continued strengthening this fictitious liquidity by boosting the stock market with more than 3500 million euros every year since 1988. This chorus of shares and paper assets increased in the 2000s as more businesses entered the market and ramified their activities in the banking, financial and other services. Large amounts of accumulated income on the part of middle and lower middle classes were taken away, free of tax, from the financial capital through the ASE and without adding one iota to the competitiveness of the Greek economy. It is no accident that from the mid-1990s onwards hitherto unknown businessmen and companies appeared, amassing a number of activities in Greece, the Balkans and the Near East, in the field of banking, construction, defence equipment and procurement (including offset agreements), large scale import–export, mass media, informatics and energy, all phenomena

Table 6.1 Athens stock exchange—share price indices 1980–2010

Year	Share price indices	Annual change in price indices
1980	74.9	
1985	50.4	–24.5('80–'85)
1990	488.3	437.9('90–85)
1995	914.15	425.85('90–95)
1996	933.48	19.33
1997	1479.63	546.15
1998	2737.6	1257.97
1999	5535.1 (on 17-9-1999 it peaked at 6335)	2797.5
2000	3388.9	–2146.2
2001	1748.4	–1640.5
2002	2263.6	515.2

Source: Our compilation of data from *Concise Statistical Yearbooks for the Respective Years,* Hellenic Statistical Agency (ELSTAT)

that should be seen in conjunction with the policies of privatisation and deregulation—the essence of Costas Simitis' 'modernisation' agenda after he assumed power in 1996 just before the death of Andreas Papandreou.

From 1994 to 1999 more than 100 companies had been privatised, the most important being AGET-Hercules, the cement company; Hellenic Shipyards; Peiraiki Patraiki (textiles) and a number of banks, including ETVA (Hellenic Industrial Development Bank). The privatisation of Olympic Airways, the country's loss-making airline carrier, was blocked by its workers, but was eventually carried out in the late 2000s.[1] Given the small size of the country, an unusual number of new commercial banks sprang up, including European and international banks and their subsidiaries. In the end, however, following privatisation, the Greek banking sector pursued a triple strategy.

First, instead of adopting an expansionary investment strategy to deal with increasing international competition *vis-á-vis* the country's entry into the Eurozone, the Greek banks pursued an aggressive policy of mergers and acquisitions bringing about an oligopolistic condition to the Greek financial sector and high profits. Greece has some 61 banks of which 34 are Greek, 33 branches that belong to banks from EU countries and five banks from outside the EU. But only five commercial banks control nearly 70 % of the liquidity market in Greece of which 80 % is owned by Greek banks.

It is worth noting that, according to the Governor of the Bank of Greece in 1998, the profitability of the Greek banks was much higher than in other European countries. But this was due chiefly to the second type of strategy adopted by the banks, which was massive lending to the Greek government (Bank of Greece 2011, 273–277). For more than ten years (1999–2009), the Greek banks, through lending to the Greek governments, presented massive profits on their balance sheets, at the expense of the Greek taxpayer (Fouskas and Dimoulas 2013).

According to a research paper published by Constantine Manolopoulos (Manolopoulos 2011), in 2010 the National Bank of Greece had an accumulated holding of Greek debt of 17,9 million euros, or 88,6 % of its investment portfolio; Piraeus Bank (of the Sallas family) 7,3 million

[1] It should be noted that all the privatisations that occurred from 1991 to 2010 brought only 20 billion euros to the state, mainly used to sustain borrowing and the remaining lame-ducks.

euros or 83 % of its investment portfolio; EFG-Eurobank (of the Latsis family) 7,3 million euros or 97,1 % of its investment portfolio; Greek Postal Services (state-owned) 5,6 million euros or 98,5 % of its investment portfolio; Alpha Bank (of the Kostopoulos family) 4 million euros or 87 % of its investment portfolio; AteBank (state-owned) 3,4 million euros or 75,6 % of its investment portfolio; and the Commercial Bank, which is owned by the French Credit Agricole, 1,7 million euros or 83,2 % of its investment portfolio. As a result of the bailout agreements and the recapitalisations advanced, the Hellenic Postbank merged with Eurobank (Table 6.2).

Table 6.2 Mergers and acquisitions in the Greek banking sector 1997–2010

Piraeus Bank	1997 acquisition of	Chase Manhattan's activities in Greece
	1998 acquisitions of	Bank of Macedonia-Thrace
		Credit Lyonnais Greece
		Chios Bank
	1999 acquisition of	UK National Westminster's branches in Greece
	2001 acquisition of	ETVA (Greek Bank for industrial development)
EFG-Eurobank	1996 acquisition of	Interbank
	1998 acquisitions of	Bank of Athens
		Bank of Crete
	1999 acquisitions of	Bank of Labour
		Dorian Bank
	2001 merger of	Telesis Investment Bank
Alpha Bank	1999 acquisition of	Ionian Bank
National Bank of Greece	1998 acquisition of	National Mortgage Bank which acquired National Dwelling Bank in 1997
	2006 acquisition of	Turkish Finansbank
Marfin Bank	2003 merger with	Investment Bank
	2007 merger with	Egnatia Bank which acquired the Bank of Central Greece a popular bank in 1997
Societe Generale	2003 acquisition of	General Bank
Credit Agricole	2000–2010 step-by-step acquisition of	Commercial Bank of Greece (Emporiki)
Aspis Bank	2002 acquisition of	ABN AMRO's branches in Greece.

Source: Author

The third strategy pursued by the banks under this new regime of neo-liberal financialisation in order to increase their speculative profits and assets was the aggressive promotion of 'new products', such as mutual funds. These funds absorbed a significant amount of the savings of ordinary people. The asset value of mutual funds in Greece was 1.1 % of GDP in 1990, 5 % in Portugal, 3.1 % in Spain, 5.5 % in Ireland and 3.7 % in Italy. But seven years later in 1997, the asset value of mutual funds soared to 22.4 % of GDP for Greece, 26 % for Portugal, 34,9 % in Spain, 69,9 % in Ireland, 18,9 % in Italy and 24.7 % in prudent Germany (Bank of Greece 1998, 279). We can see here the bubble of financialisation in the 1990s getting almost out of hand not only in Greece but across Europe, with Ireland standing out as a peculiar case with a high vulnerable banking sector. It is those paper assets (debt) which had been inserted in the statistics appearing as 'real' GDP growth, what in fact had been debt, portfolio and bond activity, as well as other services and products circulating in Greek, European and global markets. This all went hand in glove with the destruction of the productive (primary and secondary) sectors of the economy, which were now completely unable to compete internationally. Thus, when the crisis kicked in and blew up the chain of debts and paper assets across the European banking sector, the International Monetary Fund and the ECB were among the first to step in to recapitalise them, defending their Balkan kin, by which time it had amassed an amazingly brave operation in the financial and security markets of the Balkans and the Near East (Table 6.3). By the end of 2011, the Greek banks had received 86.8 billion euros from the ECB and nearly 30 billion euros from the Greek government. But this is now taxpayer money that the Greek citizens have to pay. The creditors support this solution because the assets of the Greek banks do not belong to any public utility whose main shareholders are the Greek people, but to investment funds and foreign interests holding nearly 82 % of their shares, whereas their official owners own less than 10 % and the Greek insurance fund less than 5 %.

Back in December 1996 cotton growers protested violently against the government for refusing to reschedule about $1,3bn in debt owed to the state-controlled Agricultural Bank and to obtain reinstatement of a tax break on fuel. Strong protests also took place in Athens in 1998, when PASOK Finance Minister, Yannos Papantoniou, in coordination with

Table 6.3 International activities of Greek Banks in 2010

Country	Asset value in million euro	Loans in million euro	Deposits in million euro	Number of branches	Number of ATM
Egypt	2018	979	1477	65	120
Albania	1750	1352	1223	157	212
Bulgaria	11,461	9460	5530	706	1443
UK	6799	1447	1680	6	0
USA	628	394	544	13	16
Cyprus	13,730	7688	8068	87	88
South Africa	141	121	107	11	7
Ukraine	1291	926	463	153	158
Former Yugoslav Republic of Macedonia (FYROM)	1254	855	935	91	136
Poland	5693	5184	3262	335	0
Romania	17,347	12,506	5661	845	1387
Serbia	4931	3609	2160	471	514
Turkey	23,348	16,762	12,444	556	1629
Total	90,391	61,283	43,554	3496	5710

Source: Our own estimates based on data from the Union of Greek Banks (2011)

the managing directors of the Commercial Bank, announced the tendering of a majority stake in its Ionian subsidiary.[2] In 1998, the drachma was devalued by 12.1 % against the Ecu, as the price of entry to the : European Currency Unit (ERM). By the end of the millennium, Greek state authorities were presenting highly positive statistical data vis-à-vis the country's entry into the Eurozone, which was scheduled for 1 January, 2001, two years after the launch of the euro for the core of Europe: GDP was around 3.5 %, one of the highest in Europe; inflation was down to 4 % and the budget deficit had shrunk to 1.9 % of GDP, well below the Maastricht convergence ceiling of 3 %; the interest rate of a 12-month Treasury bill in 1997–8 ran at 9.5 %, with the EMU fluctuating criterion

[2] Interestingly, and when the Commercial Bank was in full neo-liberal swing, its managing director from 2000 to 2004 was Yiannis Stournaras, Minister of National Economy from June 2012 until January 2015.

being 7.8 %. Meanwhile, international lenders began bidding for contracts with the Greek government in the run up to the Athens Olympics of summer 2004, just as Greek rentier/financial capital penetration into the new Balkans/Near East assumed enormous proportions.

6.5 The New Comprador Element and the Collusion Between 'Modernisation' and Corruption

Companies such as the Alpha Group, Mytilineos S.A., Bobolas S.A., Intracom Holding S.A., Marfin Bank, MIG and the Sfakianakis Group, began dominating the new business environment. The Sfakianakis Group, for instance, which started in the early 1960s manufacturing buses, saw its profits declining in the 1980s and quickly diversified into comprador activities, becoming Greece's prime car importer from Germany, France, Italy and the USA. Greece's telecommunications operator, OTE, while under a programme of partial privatisation, bought Romania's Rom Telecom, defeating Telecom Italia, the only other bidder. US companies provided technology and other capital for further modernisation. The Mytilineos business group bought Romanian SC Somerta Copsa Mica, a lead and zinc smelter company, with a view to expanding it into metal processing boosting its supplies to Kosovo and Macedonia/FYROM. Cement manufacturing Titan, in a joint venture with Holderbank of Switzerland, acquired Macedonia's plant Cementamica USJE. Latsis, a London-based shipping company, participated in investment ventures in Bulgaria and Romania through the Euro-merchant Balkan Fund, operated by Global Finance, a Greek venture capital fund manager. Around the same time, Spiro Latsis set up Eurobank EFG in Greece, the third largest private bank in Greece, recycling paper and values stemming from oil trade and equity investment in Poland, the Ukraine, Turkey, Serbia, Romania and Bulgaria. In this delirium, divided Cyprus, an EU member state since 2004, was an offshore paradise and tax haven accommodating rentier and financial activities, whether of Greek, British, Russian, Serbian or Persian Gulf ori-

gin.[3] At the same time, Cypriot banks, which have a significant presence in the Greek market, kept buying Greek debt in increasing quantities. Thus, straight polygonal lines connect Dubai, Cyprus, London, Athens, Cairo, Sofia, Belgrade, Damascus and Moscow, reflecting the new geography of parasitic capital with no growth prospects in the carriage bag of its travellers. In this Eastern and Middle Eastern geographical architecture, Athens was a key pawn and conduit in the service of financialisation and neo-liberalism. It should be noted that the amount of tax evasion of this new super-rich comprador along with the financial class was enormous.

None of the aforementioned activities were conducive to growth. Greek investments in the real economy involved small and medium size enterprises in the textile and brewing industries in Greece and the Balkans, but this could neither offset nor arrest the new domination by financial and rentier/comprador capital, that is the *capital of debt, corruption and tax evasion*.[4] Simitis' 'modernisation' and 'anti-populist' programme co-constituted this new reality which penetrated deeply into Greece's social tissue, destroying the social mores and culture of working class and agrarian communities. As the organic produce became increasingly replaced

[3] Greek shipping capital, a prime international force in world seaborne trade with no substantial base in Greece, should also be brought into the equation. Also, part of the Greek merchant fleet is listed in the shipping register under flags of convenience, so no substantial tax income can be raised by the Greek state. This loss of income becomes even more significant in the 1990s and 2000s, as the world share of the Greek merchant fleet—under confirmed Greek ownership—which was 1 % in 1947 and 12 % in 1970, soared to 17.4 % in 2000. Unlike other nationalities, Greek ship owners are under no legal compulsion to enter or remain on the Greek registry and they do so only in periods in which favourable tax regimes—such as laws 2687/1953, 89/1967 and 378/1968—come into force. Most Greek shipping is 'tramp', rather than 'liner' shipping. The former is conducted by vessels, which go like taxis wherever the charterer wants, with freight rates fixed in a free global market. The latter is conducted by vessels/liners, which run like buses on regular schedules and according to predetermined routes and tariffs. Having said this, the only significant contribution of Greek shipping to the Greek economy is its net contribution to invisible earnings and employment.

[4] Even in the middle of the debt crisis in September 2011, Athen's daily press reported that Mytilineos S.A. buys from the state electricity company, DEI (PPC S.A.), energy at 41 euros per MegaWh, only to sell it back to DEI for 55 euros per MegaWh. How is this possible? Mytilineos, who runs aluminium business, received a licence by the Greek state to buy cheap electricity for his aluminium business. But he had set up a separate energy unit for himself, ending up selling back energy to DEI at a higher price. This type of domestic comprador activity against the interests of the public at large is not just damaging to state performance; it is insulting. None of the press reports about it have been denied or contradicted.

by the imported genetically modified product of the core, the best the local producer could do was to embrace the international domination of his/her market becoming a petty comprador. At the same time, Simitis created a new type of social alliance, the 'social alliance of modernisation', gathered around the 'party of the stock exchange' and unified via a complex paralegal corruption network forming a new bipartisan consensus across the trembling party system of post-1974 Greek politics. PASOK and ND were now united behind a range of wheeling and dealing related to acts of privatisation, management of state financial flows and recycling of debt, defence expenditure (discussed later), rearrangement of privileges and redistribution of benefits and political clientele. It can be argued, therefore, that despite the fact that the class determinants of the Greek bourgeoisie had been changing, the coalition of power and the structure of the ruling bipartisan class, including the large number of civil servants, remained unaltered. The structures of dependency and subordination of the Greek state elites to Euro-Atlantic power centres also remained the same.

Neither Simitis' 'modernisation' and 'anti-tax evasion' program (1996–2004), nor the similar 'modernisation' program pursued by the ND cabinet under Karamanlis Jr. (2004–09) brought any benefit to state finances. According to multiple announcements by the Ministry of Finance in September–October 2011, more than 6000 individuals owe more than 150,000 euros each to the Inland Revenue. For the sake of comparison, the total amount these individuals owe to the tax authorities are in the region of 30 billion euros, whereas the annual spending of the Greek state for wages is less than 23 billion euros. It was no accident, therefore, that the public debt doubled from 2000 to 2009, and at the expense of the average Greek consumer. Yet this abrupt rise was not accompanied by an increase in the productive output of the economy, as the country's GDP presented a less dynamic structure (Table 6.6). Interestingly, if we also factor in defence spending, justified purely on *ideational* rather than *real* grounds, this dimension of public spending not only added to the debt structures of the country, but also extended corrupt practices to the heart of the state.

One of the reasons why France, in the first place, and Germany were the main holders of Greek debt is because Greek political elites, in their 'patriotic attempts' to move away from the USA's pro-Turkish grip, began using French and German weapons suppliers. By exaggerating both the threat coming from Turkey and Greece's and Cyprus's own vulnerability, the 'realists' of the Greek cabinets could bid for high-tech expensive military gear: in 2009 defence expenditure in Greece was over 3.3 % of GDP, as opposed to 2.4 % for France, 2.7 % for Britain, 2 % for Portugal, 1.4 % for Germany, 1.3 % for Spain and 4.7 % for the USA. At the beginning of the full-fledged crisis of 2010, Greece bought six warships from France at a cost of 2.5 billion euros and six submarines from Germany at 5 billion euros. Between 2005 and 2009, Greece was one of the largest European importers of weaponry. During that period, the purchase of 26 F-16s from the USA and 25 Mirage-2000 from France represented nearly 40 % of the total import volume of the country. According to SIPRI (Stockholm International Peace Research Institute) data for 2006–2010, Greece is the fifth largest weapons importer in the world, with a global quota of 4 %, about half that of India's (9 %), and two thirds of China's imports (6 %)—it is worth noting that the Chinese GDP is about twenty times bigger than Greece's nominal GDP (Fouskas and Dimoulas 2013). Most of these transactions took place through the Greek state issuing debt, that is, pieces of paper. In Greece, there is no such thing as an 'industrial-military complex', but rather a *comprador-military complex*, a key faction within the wider financial/comprador oligarchy network, which is dominated by the Ministry of Defence, doing all sorts of wheeling and dealing under the radar of a liberal Constitution and the taxpayer. In 2011–12, for example, Akis Tsochatzopoulos, a highly regarded PASOK cadre who challenged Simitis for the party leadership in 1996, was being investigated and imprisoned with regard to his activities as Minister for National Defence between 1996 and 2001. Accusations against him include bribes he and his associates received for defence systems—mainly submarines and Patriot batteries—that were bought under his leadership. Thus, the entire security of the country is a dependent spoke of the Euro-Atlantic core, whether American or Franco-German.

6.6 EU Transfers to Greece and the PIIGS Cannot Stop the Debt Spiral

Having said this, the doubling of the Greek public debt from 2000 to 2009 (Table 5.6) should not be surprising. In addition, we can see from the table the increase of extra charges for the Greek taxpayer (5th column) all of which had been happening without any corresponding increase in productivity and output. The Greek GDP has been growing at a much slower pace than the debt (3rd and 4th columns). The ruling parties of ND and PASOK became increasingly unable to manage the debt. The structural funds coming from the EC/EU also did very little, if anything at all, to improve social cohesion and productivity in Greece and other PIIGS (Portugal, Ireland, Italy, Greece and Spain) (Tables 6.4 and 6.5). A careful look at the empirical evidence we possess suggests that during 2000–09 EU transfers towards the PIIGS never went above 1.53 % of GDP, or 220 euros per person per annum. In fact, the so-called structural and cohesion funds disintegrated the productive structures of the PIIGS even further, instead of advancing sustainable development, real growth and socioeconomic cohesion.

Moreover, the import/export ratio from 1994 to 2009 shrank at the expense of exports and despite significant growth. Thus, the international competitive position of Greece worsened, the export-led manufacturing sector disintegrated further, and all this despite high borrowing and the rise in the share price index of the ASE. Further, the structure of exports

Table 6.4 Impact of the EU structural funds in Cohesion (PIIGS) countries, 1986–2006

	Gross Value Added (GVA % per annum)			Investment in knowledge-ICT (% per annum)			Labour productivity (% per annum)		
Country	86–93	94–99	00–06	86–93	94–99	00–06	86–93	94–99	00–06
Greece	2.63	3.19	3.36	−0.01	−0.03	−0.02	0.974	0.883	0.576
Spain	0.60	1.55	1.96	−0.01	−0.03	−0.04	0.193	0.565	1.008
Ireland	2.86	3.52	2.72	0.03	0.12	0.16	0.981	−0.106	0.407
Portugal	3.58	5.63	4.78	−0.02	−0.03	−0.05	0.724	1.882	1.671

Source: Our compilation of data from GHK (2002) and GHK/PSI/IEEP/EC (2003)

Table 6.5 EU cohesion funds committed to PIIGS, 2000–09 (in 1999 prices)

Country	Total resources	Per person/ per annum	Percentage of national GDP	Cumulative impact in GDP 2000–09
Greece	23.80 billion euros	220 euros	1.25	15.89
Spain	54.30 billion euros	140 euros	0.62	16.67
Ireland	3.76 billion euros	100 euros	0.25	7.47
Portugal	22.50 billion euros	220 euros	1.53	16.75

Sources: Our compilation of data from EU (2010) and Martin, R. (2003)

over imports shows the magnitude of the problem, caused by a combination of the uneven development between the core and the peripheral Greek state and of the policies pursued by the 'new' coalition of power (PASOK + ND + new financial comprador bourgeoisie) straddling the geopolitical fault lines of the country. From 1994 to 2009 the Greek economy lost almost 40 % of its competitiveness despite the fact that GDP growth remained relatively good, whereas the period 1999–2004 was the highest in the EU; domestic and external borrowing increased; and the ASE's price index was doing quite well. In this respect—manipulation of statistics apart—the relatively wealthy picture of the Greek economy before the current crisis was not because of the improvement of the real economy, but rather the speculative, rentier and consumerist activities of the new business and middle classes, coupled with the recycling of European/German financial surpluses in the country's account and banking system (Table 6.6).

The borrowing requirement of the Greek state increased rapidly after 2001. This was a result of further internationalisation/Europeanisation of the Greek state with the insertion of the country into this peculiar form of world money, the euro. We see that whereas the initial loans were sourced domestically, this ceased to be the case after 2007, as the 2007–08 financial crisis wiped out the accumulated wealth of small paper-asset investors, while at the same time the Greek state was forced to pump money into the banks degrading the structure of the budget deficit. This, in turn, could *not* have been offset by European funds whose volume was not sufficient (Table 6.7, column 4). It is clear to us that from 2007 onwards the Greek debt has been split between national and international/European agencies and structures. Thus, the 'haircut' agreed at the end of October 2011 and effected in the second bailout of February–March

Table 6.6 Evolution of the Greek public debt and its relation to GDP in USD

Year	Public debt	Annual change	% Annual change in GDP	Public debt per person	% Annual change in public debt per person
2000	139,689,071,038	10,087,641,291	100	12,840.70	100
2001	149,776,712,329	28,884,931,507	107.2	13,701.68	106.7
2002	178,661,643,836	47,538,356,164	119.3	16,293.75	118.9
2003	226,200,000,000	47,538,356,164	126.6	20,602.64	126.4
2004	272,540,983,607	46,340,983,607	120.5	24,820.27	120.5
2005	271,193,150,685	−1,347,832,922	99.5	24,701.92	99.5
2006	287,170,808,219	15,977,657,534	105.9	26,211.64	106.1
2007	329,765,753,425	42,594,945,206	114.8	30,014.36	114.5
2008	346,575,409,836	16,809,656,411	105.1	31,555.10	105.1
2009	385,542,465,753	38,967,055,917	111.2	35,082.30	111.2
2010	378,241,095,890	−7,301,369,863	98.1	34,419.71	98.1
2011	375,772,602,740	−2,468,493,150	99.3	34,172.04	99.3
2012	393,420,821,918	17,648,219,178	104.7	35,741.33	103.8

Source: Our compilation of data from http://www.economist.com/content/global_debt_clock and Hellenic Statistical Agency (ELSTAT 2011)

2012, applied to the Greek banking sector, which found it impossible to survive without substantial recapitalisation from European Financial Stability Facility (EFSF) funds. Time and again, this re-capitalisation was being carried out at the expense of the taxpayer, leading mathematically to a creditor-led default, as initially pushed for by Germany and as the third round of austerity in Fall 2012 showed. Greece is unable to service its debt or ever pay back some of the principal because the actual and projected rate of growth from 2010 to 2013 ranged between −2,5 % and −7,5 %, whereas the interest rate for borrowing has always been above 3 %. Moreover, the European banking system, too, seems to be unable to cope with the stress on its peripheral banks and pension funds inasmuch as the degree of leveraging takes on enormous proportions. Greek banks alone, for example, are dependent on ECB credit lines that amount to over 100 billion euros (Fouskas and Dimoulas 2013). The new ruling classes of Greece, together with their Western masters, have failed spectacularly to deliver growth and sustainable development. What they deliver, though, is a peculiar form of 'creative destruction', whereby the mechanism of national and international debt generates forms of primi-

tive accumulation, in other words, social destruction and pauperisation (Tables 6.7 and 6.8).

There is no doubt, therefore, that whereas the trade deficit and various forms of external borrowing, especially during the period of low interest rates, are substantial sources of the overall Greek debt, numerous other factors, mainly of domestic origin, have to be factored into every calculation. Trade deficits are articulated in the current account, and especially in the structure of the unequal/unequivalent trade interaction between Greece and the European core, particularly Germany, Italy, France and the Netherlands. Approximately 70 % of Greek imports come from Europe, whereas about 55 % come from EU member states. Germany's share of total imports is 12 %, Italy's 11 % and France's 6 %. Of the total of Greek exports, some 64 % goes to EU member states (11.5 % to Germany, 11 % to Italy, 4.2 % to France). On the surface, it appears that the import/export relation is in equilibrium, but this is not the case. In terms of absolute value, Greek exports to Germany are in the region of 1.9 billion euros, whereas the value of German exports to Greece are in the region of 7.2 billion euros (Fouskas and Dimoulas 2013). But there is also the dimension of financial account. This can take various forms: FDI, portfolio flows and other flows driven by the banking sector of the core. Recycling of German surpluses becomes clear from the overall composition of German exports over imports, thus accelerating the pace of concentration of the overall debt. In this context, the analyses by Lapavitsas et al. are meaningful:

> [I]nternational transactions of Euro-zone countries have been driven by the requirements and implications of monetary union. Peripheral countries have lost their competitiveness relative to Germany because of initially high exchange rates as well as because of the ability of German employers to squeeze workers harder. The result has been a structural current account surplus for Germany, mirrored by structural account deficits for peripheral countries. Consequently, German FDI and bank lending to the Euro-zone have increased significantly. 'Other' flows to peripheral countries rose rapidly in 2007–08 as the crisis unfolded, but then declined equally rapidly. That was the time when peripheral states were forced to appear in credit markets seeking funds. (Lapavitsas et al. 2010, 344)

Table 6.7 Annual loans of the Greek State, state receipts, receipts from EC/EU and expenditures

Year	Domestic loans	Foreign loans	Receipts from EC/EU	Receipts	Expenditures	Receipts-expenditures
1998 (million drachmas)	9,609,693	1,344,888	98,202	9,521,604	21,378,017	–11,856,413
1999 (million drachmas)	8,365,025	1,272,140	114,189	10,626,457	21,253,001	–10,626,544
2000 (million drachmas)	5,454,921	1,695,821	119,077	12,186,488	21,602,748	–9,416,260
2001 (thousand euros)	14,990,301	1,773,632	2,658,226	41,021,321	60,443,281	–19,421,960
2002 (thousand euros)	29,956,909	379,321	1,371,316	37,437,431	69,144,977	–31,707,546
2003 (thousand euros)	35,934,079	2,034,098	1,052,393	37,866,221	76,952,341	–39,086,120
2004thousand euro	40,165,350	9,882,539	2,810,607	39,859,803	92,781,544	–52,921,741
2005 (thousand euros)	39.416.790	5,379,852	2,623,819	42,969,056	90,437,198	–47,468,142
2006 (thousand euros)	27,439,833	9,715,000	3,563,523	47,363,182	88,122,280	–40,759,098
2007 (thousand euros)	35,822,354	25,544,219	4,810,946	49,962,035	116,178,904	–66,226,868
2008 (thousand euros)	34,906,408	34,754,244	4,668,300	52,530,042	126,912,696	–74,382,654

Source: Calculations based on data from the concise statistical yearbooks of ELSTAT for the respective years. Hellenic Statistical Agency (ELSTAT)

Table 6.8 Annual change of export over imports, the share prices in Athens stock exchange and gross domestic product in market prices

Year	% Exports over imports	Share price indices	Annual change of gross domestic product in market prices
1994	43.9		110,9
1995	43	914.15	110,9
1996	41.4	933.8	107.4
1997	41	1.479.63	106.8
1998	35.9	2.737.6	105.2
1999	36.3	5.535.1	103
2000	35.1	3.388.9	103.4
2001	36.8	1.748.4	104.2
2002	31.5	2.263.6	103.4
2003	29.8	2.263.2	105.9
2004	29.1	2.786.2	104.4
2005	32	3.663.9	102.3
2006	32.4	4.394.13	105.2
2007	30.9	5.178.83	104.3
2008	28.6	1.786.51	101
2009	36.3	2.196.16	98
2010	28.7	1413.94	95.5

Source: ELSTAT. Our compilation of data from the *Concise Statistical Yearbooks* and the national accounts of Greece

6.7 Concluding Remarks

We can now draw a few conclusions:

(a) Greece had always occupied a dependent/subaltern position in the global and European division of labour. The dominant class element in Greece's economy has always been of a comprador nature, that is, large import consortia and small commodity forms of production and consumption. As such, it followed economic developments and trends initiated outside Greece, rather than led them. The structures of dependency deepened further with Greece's insertion into the post-Bretton Woods financialised capitalism and the adoption of the euro as its national currency in 2001. This disintegrated further the productive base of the country and increased its debt obligations. Greece had become far more uncompetitive within the Eurozone than it had been outside it.

(b) The high growth rates of the post-1995 period in Greece are not a result of the improvement of the real economy (productivity, technological innovation, output and valorisation), but due to the speculative and consumerist activities of middle to upper middle classes and the comprador together with financial elements that have dominated the Greek social formation since then. The Athens Stock Exchange and offshore business interests escaping taxation, coupled with aggressive penetration of the Greek banking sector in the Balkans/Near East/North Africa—which was basically used as a conduit of German and French financialisation plans for the region—constituted the form that 'asset price Keynesianism' (Robert Brenner) assumed in Greece. Alongside this picture one can draw the profile of the new comprador bourgeoisie, the main agent of dependency for the country. The main difference with the comprador element of the past is that this time around the commodity traded is primarily, but not exclusively, fictitious rather than real. Financialisation and neo-liberalism have shattered the country's already weak productive-material base.

(c) The entry of the country into the Eurozone has accelerated the proliferation of the country's debt but, as such, it did not cause it. A Greek bankruptcy could have happened anyway, as it happened in the past and when the country was not participating in any currency union—having its currency pegged to an imperial currency was enough to cause havoc. Greece has never really been solvent. Bankruptcy was bound to happen and may have happened much earlier had it not been for the geopolitical and security circumstances of the end of the Cold War and the need for the Euro-Atlantic powers—especially the USA—to have (and use) Greece and Turkey as anchors of stability in the Balkans and the Near/Middle East. Greece was used by Germany as a platform for the financialisation of the Balkans and the Near East.

(d) The sources of the Greek debt crisis are both internal and external and, in general, pertain to the historical fault lines of the country: a weak capitalist economic structure relative to the advanced core; and a relatively important geopolitical/regional position relative to its real economic assets and industrial/technological base. The management of those fault lines by the coalition of PASOK-ND in the post-1974

period proved, as in the past, to be subordinate to the class and security interests of the core, unable to articulate independent, national/class claims against it. The party system remained a wholly dependent spoke of the Euro-Atlantic hub and a corrupt administrator in managing the representation between itself and civil society. Myriad financial, geopolitical and class interests, hemmed in by corrupt deals, cut across the *vertical* articulation of corporatist interests between PASOK-ND and civil society, on the one hand, but also the *horizontal* articulation between PASOK-ND and the Euro-Atlantic core, on the other. *From this perspective, as we have argued elsewhere, this Greek tragedy is the making of the Greek and Euro-Atlantic ruling classes* (Fouskas 2011). Sadly, the new radical party of Syriza seems also unable to confront the corrupt structures of subordination and dependency of the country on the Euro-Atlantic core and the new financial comprador element. The three successive bailout agreements signed one after the other by the whole political spectrum of Greece—first from socialists PASOK, then from Right-wing ND and lastly by radical left, SYRIZA—did not change an iota as regards the structure of the constraints imposed on Greece and its peripheral, subaltern position. The huge amount of money demanded for too many years into the future from the Greeks does not allow any room for progressive developments. Greek society and other peripheral countries are hostages to the European core lacking any serious prospect for sustainable development. Foreign direct investments are directed to the dispossession of public goods and infrastructures rather than financing innovative and productive activities and at a moment when the remaining domestic capital evaporated for the sake of the European Banking sector. Once again, the country faces the abyss.

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7

Assessing the Italian Experience in the Eurozone

Leila Simona Talani

7.1 Introduction: The Sovereign Debt Crisis in Italy

From the second half of 2011, Italy experienced an increased pressure on its sovereign debt from financial markets. From July to November 2011 the spread between the Italian BTPs (Italian 10 year treasury bills) and the German Bund, a common measure of such pressure, surpassed 400 basis points on many occasions. Although it was generally felt that the situation was extremely serious, this indicator tends to maximise the effects of the pressure on interest rates as it is strongly influenced by the reduction of the interest rates paid on the Bund, which, given the instability of the global economy, were selected by investors as a safe haven.

In the same period, the interest rates of Italian long term debt emissions increased steadily to reach the quota of 6.99 % in November 2011. However,

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L.S. Talani (ed.), *Europe in Crisis*,
DOI 10.1057/978-1-137-57707-8_7

the Bank of Italy noticed how the fiscal position had not yet become unsustainable. First of all, during the crisis Italian debt did not remain unsold[1] and the allocation of Italian Treasury bills happened regularly.

Moreover, in June 2011 Italian public debt was around 1900 billion euros. Only 39.2 % was held by foreign investors, which is a relatively small percentage as compared to other European countries. Italian families held the biggest part of the debt, with residents holding around 14 %, followed by banks, insurance companies and funds.[2] The composition of debt ownership did not change substantially in the course of the crisis apart from an increase in the quota held by Italian banks.[3]

Finally, some the pressure on Italian debt needs to be inserted in the context of a liquidity shortage which brought many European investors to sell assets.

Despite some evidence to the contrary, there was a widespread belief that Italy was on the verge of default. This was influenced by the extent that the political equilibrium of the country, resting on the centre-right government of Silvio Berlusconi, was shattered to the point of no-return. Amid fears of a fiscal melt down, Mario Monti, a technocrat with great experience both of the European Union (EU) and of financial markets, was able to form an unelected government with the only ostensible aim of calming down the markets and allowing the fiscal crisis to ease.

What was the price that the markets asked in exchange for a truce on their attacks on the Italian sovereign debt? There is no doubt that much of Monti's success in calming down the markets was due to a decree on market liberalisation. The Italian capitalist system has long been known for being extremely closed to foreign investment. The system allowed Italian capital to keep control of the Italian economy. It revolved around a web of cross-shareholdings that allowed the financial and corporate elite to sit on each other's boards and wield influence over several companies often through only a small stake.

Mario Monti identified the dismantling of this so called Italian 'Salotto Buono' (i.e., the Italian capitalist establishment) as the price to pay to

[1] See Bank of Italy 2011.

[2] See Bank of Italy 2011.

[3] See Bank of Italy 2011: 61.

financial markets. Indeed in Mr. Monti's 'Save Italy' liberalisation decree it was made clear that from 25 April, 2012 it would be illegal to hold a board seat in more than one financial institution operating in the same market. The aim was clearly that of opening to foreign financial capital Italy's triumvirate of boardroom power, UniCredit, Generali and Mediobanca, where no less than six men sit on at least two out of the three boards.[4]

Moreover, these companies were linked by cross-shareholdings. Mediobanca owned 13 % of Generali and 7 % of UniCredit via a structured finance deal. UniCredit owned 9 % of Mediobanca. It is worth noticing that through this system, Mediobanca, the productive investment powerhouse of Italy, the mother of Italian family capitalism, influenced strategic choices at Generali, Europe's third-largest insurer by assets. By eliminating such a link, Italian capitalism was out for sale to the same financial markets that attacked its sovereign debt.

Mr. Monti's decision was very controversial in Italy, where discussion opened on whether there was a loophole in the decree and if article 36 really meant what it appeared to say. As one senior board member of an Italian bank said: 'If you have one or two of those seats, you really don't want to give them up.'[5]

But it seems clear that Monti was determined to put Italian relationship capitalism to an end and satisfy foreign investors' long term desire to get their feet in the door by opening up a system that has traditionally been impenetrable to all but powerful insiders.

As Monti said at a press conference: 'It is natural and dutiful for the government to be open to a dialogue with parliament,' but some changes to the liberalisation decree 'cannot and will not be welcomed'.[6]

To be sure, financial markets welcomed a similar approach. Riccardo Barbieri, of Mizuho International, praised Mr. Monti's government for its accomplishments but said the vote on the liberalisation package and the labour reform negotiations were 'critical'.

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[4] See FT, 24/02/12.

[5] See FT, 24/02/12.

[6] See FT, 24/02/12.

'Deregulation is necessary and will challenge the government's ability to win concessions even from the strongest lobbies and to change the structure of the economy,' he said.[7]

So, in order to appease the markets and end speculation, Italy had to sell its 'salotto-buono'. But how did Italy get to this point? What went wrong in the relationship between Italy and the European Monetary Union (EMU)?

This chapter will answer these questions by looking at the history of Italian commitment to the EMU with a focus on the power-relation between the different socioeconomic interest groups as historically developed. In particular, it will assess the role of the power struggle between the employers and employees' organisation as a heuristic tool to evaluate the consequences of Italian entry into the EMU.

7.2 Internal Devaluation and Structural Imbalances in the EMU

If we consider the global financial crisis as an asymmetric shock, as proposed in the introduction to this book, it is easy to identify the neo-functionalist case leading from the EMU crisis to structural reform of the labour markets. Asymmetric shocks are defined as economic shocks (both demand side and supply side ones) that hit different countries or regions of a currency union area in distinct ways. These are likely to happen within the Euro Area as this does not meet all the requirements of an Optimum Currency Areas (OCA).[8] By definition, autonomous monetary policy and exchange rate policies are not available to react to idiosyncratic shocks in a currency union. At the same time, common monetary and exchange rate policies should be used with caution because they can have mixed results if the other members of the Union are simultaneously

[7] See FT, 24/02/12.

[8] The seminal work on OCA Theory is: Mundell, R. A., (1961), "A Theory of Optimum Currency Areas" *The American Economic Review*, 51:4, 657–67; for an application of the theory to the Euro Area see Boyoumi, T., and Eichengreen, B., (1996), "Ever closer to heaven? An Optimum Currency Area Index for European Countries", *Centre for International and Developing Economics Research Working Paper Series No. C96–078* California: University of California Berkeley; McKinnon, R., (2000), "Mundell, the Euro, and Optimum Currency Areas", *Stanford University Working Papers in Economics*, *No. 009*, Stanford University.

experiencing a business cycle operating in the opposite direction. Thus, economic theory leaves few options: fiscal policy, labour mobility and labour flexibility.

Indeed, a country could react to an asymmetric shock by using national fiscal policy both as a counter-cyclical tool, through the action of automatic stabilisers, and in the form of fiscal transfers to solve more long-term economic disparities (as in the case of the Italian *Mezzogiorno*). However, in the special kind of monetary union analysed in this chapter, the Maastricht criteria and to an even greater extent the requirements of the Stability and Growth Pact substantially limit the ability of member states to resort to national fiscal policy in order to tackle asymmetric shocks.

Alternatively, some authors suggest that the redistributive and stabilising functions of fiscal policy be performed at the European level. Proposals on this matter range from an increase in the size of the European budget to the pooling of national fiscal policies and the establishment of a Common fiscal body, which would act as a counterbalance to the European Central Bank (ECB) (e.g., Obstfeld and Peri 1998). The feasibility of similar proposals looks at least dubious in the light of the difficulties that the EU member states encounter in reaching agreement on the much less challenging task of tax harmonisation. Moreover, the discussion of fiscal policy inevitably raises more general concerns about the loss of national sovereignty. Overall, the EU member states are unable to reach agreement on the creation of a common fiscal policy or on finding some way of increasing the size of the EU budget, thus introducing a stabilisation function.

Given the difficulties in using national fiscal policy to tackle asymmetric shocks, and the lack of any substantial fiscal power at the European level, economists suggest the option of greater labour mobility. The EU does indeed provide an institutional framework within which labour mobility can be enhanced. The Treaty's articles on the free movement of workers, the Single Market programme, and recent provisions on migration are all directed toward this objective. However, economic analyses show little evidence of mass migration in response to asymmetric shocks in the EU (in contrast, in some respects, to the USA) (Obstfeld and Peri 1998). Indeed, few European policy makers would seriously endorse temporary

mass migration as a credible way of reacting to national economic strains, for obvious political as well as social considerations.

There thus remains only one policy option for national policy makers who wish to tackle the problems arising from asymmetric shocks: increasing the flexibility of labour markets so that 'regions or states affected by adverse shocks can recover by cutting wages, reducing relative prices and taking market shares from the others' (Blanchard 1998: 249). Because reform of the labour market is clearly a structural intervention, this will also help to eliminate the structural component of unemployment, in addition to the cyclical one, if indeed it is still possible to distinguish between the two (Artis 1998).

In fact, as analysed earlier, the employment rhetoric and strategy officially adopted by EU institutions in the last few years clearly shows that the European Union has chosen to give priority to labour flexibility as the favoured means of tackling the problem of unemployment in Europe.

However, this is not an automatic necessity stemming from the existence of a neo-functional relation between the implementation of the Maastricht path towards EMU and labour market flexibility but, as clearly specified earlier, the consequence of the political decisions taken, mostly in an intergovernmental fashion, by the member states within the context of the European Union institutions and procedures. These decisions were: first and foremost to establish a currency union constrained by the fiscal straightjacket enshrined in the Maastricht criteria and in the Stability and Growth Pact (SGP) in its various versions; and secondly the conclusion that the only credible way to react to asymmetric shocks and increase employment was not to rely on fiscal stimulation or even fiscal coordination, but merely on supply side measures like labour market flexibility. In other words, the entirely political decision to constrain national fiscal policy within the EMU and the even more political decision to keep European fiscal policy in a state of infancy, has led to only relying on the flexibility of labour markets to react to asymmetric shocks.

Whether these labour reforms represent the solution to the problem of growth and unemployment is indeed a different issue. As Esping-Anderson (1999) reminds us, there is a considerable gap between the widely accepted theoretical claims that deregulation will create

jobs and the evidence that rigidities seem to matter only selectively. Moreover, similar labour rigidities must be understood in the context of the societal structures where they exist. This is why we now turn our attention to the specific case of Italy and the power relation between socioeconomic sectors with respect to the flexibility of labour markets.

7.3 Labour Market Flexibility Italian Style

The expression 'flexibility of labour markets' as used by the scholars of industrial relations (Rhodes 1997) refers to three forms of flexibility:

- Internal (or functional) flexibility in the work place;
- External (or numerical) flexibility vis-à-vis the wider labour market; and
- Greater pay flexibility at local levels.

Categorising the level of flexibility/rigidity of European labour markets along the dimensions of internal and external flexibility, we can distinguish what in the literature is referred to as the 'southern cluster' (Rhodes 1997: 10–11). This is characterised by a remarkable shift from very low levels of both external and internal flexibility of the 'legal' or 'licit' labour markets in the 1970s to a much higher level of flexibility in the 1990s and 2000s. At the same time, these economies (first and foremost Italy and Spain) saw the growth of irregular labour markets and a shift from labour exporting to labour importing.

This process took place amid heated struggles between socioeconomic groups that inevitably changed the balance of power between them. In this context, the EU issues in general and EMU in particular provided the excuse to shift the power battle from the national to the European level. This shift was by no means neutral. In the move from the national to the international level, some groups acquired more strength and cohesion. Others lost a great deal of their bargaining power for reasons ranging from a decreased organisational or representative capacity to a structural bias of the EU institutional setting in

favour of certain societal interests. This game of transnationalisation is indeed played much more easily by the employers' organizations than by the unions, given the many cleavages within the European working class reflected in the cumbersome functioning of the European Trade Unions Confederation (ETUC) (Talani 2000; Ryner and Schulten 2003). Here it is underlined how, by shifting the struggle around labour flexibility in Italy and Spain between employers and employees from the national to the European level, the relative power positions between the two groups also changed, which made it easier to introduce neo-liberal labour market reforms.

Whether, though, these labour reforms represent the solution to the problem of unemployment in Mediterranean countries is indeed a different issue. The so-called Mediterranean model is often characterised as a familial one, in other words, one based on the assumption that the family male is the only bread winner (Esping-Anderson 1999). This would explain the exceedingly high levels of female and youth unemployment that are not inconsistent with a high level of labour protection and a low level of social protection. The family is the locus of social protection, and wife and children remain dependent on the income of the father up to a very late age. The protection of the job of the latter thus becomes of fundamental importance for the entire society. This model differs substantially from the liberal model, prevailing in Anglo-Saxon countries, where in the trade-off between flexibility and exclusion there is a tendency towards the former, along with all that this implies in terms of decreasing equality (Esping-Anderson 1999). And indeed in Anglo-Saxon countries a high degree of labour market flexibility produces high levels of employment at the expense of a growing wage polarisation between unskilled and skilled workers.

It could be claimed that in the era of globalisation the Anglo-Saxon model is the only viable one in view of the competitive pressures stemming from lower labour costs in less developed countries. Indeed, that is the basic argument used by the supporters of flexibility, particularly within employers' organisations. But apart from the fact that the impact of globalisation on employment is far from clear (Overbeek 2003), the price in terms of increasing inequality might

not be worth paying in countries where the societal setting is opposed to the Anglo-Saxon one. This, however, is not the place to address the many complex issues influencing the future of employment in a globalising world. Therefore we now turn to the analysis of the Italian case.

In Italy, European issues and those related to the process of European monetary integration in particular were consistently used by the leading socioeconomic groups (particularly big industry) to reduce the level of labour protection and increase the flexibility of labour markets (Talani 2000).

To analyse this in more detail the next section will first deal with the decrease in labour protection legislation in relation to Italian entry into the exchange rate mechanism of the European Monetary System (EMS). Subsequently, we will address labour market flexibility as a consequence of the EMU.

7.4 The EMS as a Labor Market Straightjacket

It is generally agreed that the first relaxation in Italian labour protection legislation was represented by the abolition of the Italian wage indexation mechanism known as the *Scala Mobile*. This was made possible by commitment to the EMS, with all that it implied in terms of strict anti-inflationary policies. The abolition of the *Scala Mobile* was a consequence of the new dominant position of Italian capitalist groups and also served to enhance their position.

The 'hot autumn' of 1969 marked the beginning of the 'era of union centrality' (Lange et al 1982: 97; Giugni 1981: 341; Regini 1981). This was an era in which Italian economic policy was characterised by prevailing concerns for the maintenance of the purchasing power of wages, the institutionalisation of workers' rights and the leading role played by the trade unions and their political counterparts in Italian socioeconomic policy making. The growing strength of trade unions during this period is reflected clearly in the ascending slope of its membership parabola, the density rates that increased constantly from 1969 onwards before

reaching their peak in 1978 with 49 % of the total employed population, an 18.2 % increase with respect to the 1969 figure (see Fig. 6.1).

The era of union centrality reached its political apex in 1975, with the signing of an agreement between the union confederations and Confindustria to upgrade the *Scala Mobile*, a system protecting workers' wages against inflation. The agreement provided for a three month payment of a fixed amount for each unit increase in the inflation rate, known as the *punto di contingenza*.[9] The main features of the agreement, which was the product of collective bargaining and not the result of a parliamentary process,[10] were the relatively high and immediate degree of inflation protection paying equal amounts to all workers and thus reducing wage differentials, and the automatic character of the system. The agreement represented a major victory for the union movement. However, the defence of this victory proved to be very problematic and, with the beginning of the economic crisis of the late 1970s and early

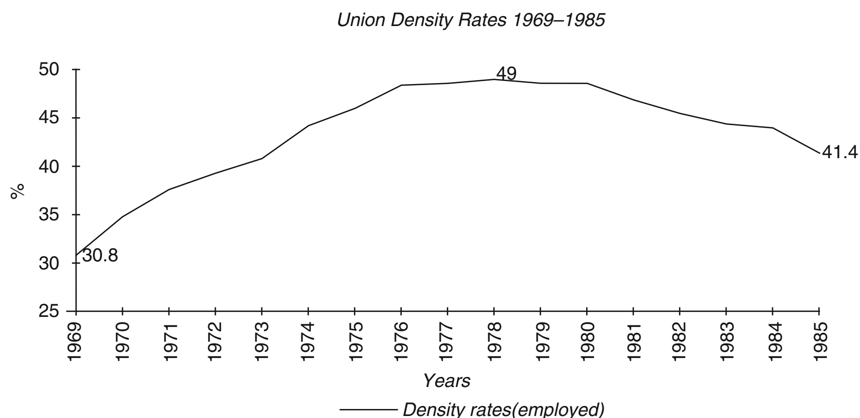

Fig. 7.1 Density of union membership in Italy 1969–1985 (*Source*: Centro Studi Economici Sociali e Sindacali, (CESOS), Le relazioni sindacali in Italia: Reports, various issues)

[9] It is important to note that in the same year, 1975, the Bank of Italy committed itself to buy all unsold Treasury Bills.

[10] Art. 39 of the Italian Constitution indicates the requisites for a collective agreement to achieve the force of law, but this article has never been implemented.

1980s, eventually led to major conflicts not only between the unions and their social and political referents, but also within the unions themselves.

In the face of the growing economic problems, particularly unemployment, the Italian Union Federation[11] adopted a new strategic orientation in 1978, called the EUR strategy. This was based on a trade off between fewer guarantees to the workers and more participation in investment decisions, and it was aimed at increasing employment through the new instrument of tripartite negotiations with the government and employer representatives. Given the increasing involvement of the Italian Communist Party in the governmental area, thanks to the pacification process between the Partito Comunista Italiano (PCI) and the Democrazia Cristiana (DC) (the so-called 'historic compromise'), this 'new course' of Italian unions appeared to secure their participation in the official sites of decision making on Italian economic policies. On the contrary, in the light of the subsequent tragic end to 'national solidarity', the EUR strategy marked the beginning of a descending parabola of union bargaining power and political influence (Accornero 1994). The historic compromise suffered a serious blow with the 1978 kidnapping and subsequent murder of DC: Democrazia Cristiana leader Aldo Moro.

The dismantling of the *Scala Mobile*, or at least the substantial reform of its mechanisms, together with the reduction of state intervention in the economy, constituted the main issues at stake in the domestic debate over the establishment of the European Monetary System. Indeed, it was precisely in the course of this debate that the differences within the governmental majority and within the union federations over the future of the *Scala Mobile* became unbridgeable. Within the union movement itself, the 'automatic' increases of the *Scala Mobile* were increasingly attacked. This is true especially for the UIL, which in this period was beginning to be controlled by the new Socialist Party (PSI) of Craxi (Merkel 1987), and for the CISL, traditionally linked to Catholic interests and to the DC. By 1982, for instance, both Pierre Carniti, Secretary General of the CISL and Giorgio Benvenuto, Secretary General of UIL, were favourable to a major reform of the wage index mechanism within the context of

[11] The Italian Union Federation (a federation of CGIL, CISL and UIL) was established in 1972 and lasted until 1984 when, during the heated debate over the *Scala Mobile*, it was dismantled.

tripartite negotiations. On the other hand, the Communist component of the CGIL was far less ready than the others to modify the system. The inconsistencies in the positions of the different unions eventually led to the first major blow to the *Scala Mobile* represented by the accord of 22 January, 1983 (30). With this accord, for the first time since 1975, the unions accepted the reduction of the automatic inflation-indexed payments coupled with an eighteen month freeze of wage bargaining in the private corporate sector. This constituted a major defeat, the significance of which should not be underestimated, even if the government agreed to protect the real purchasing power of workers by cutting taxes, limiting the rise of government controlled prices and changing the family allowance system.

Given the compromise nature of the 1983 accord and the fact that the balance of power between unions and employers was still shifting towards the latter, in late 1983 the unions agreed to pursue a possible revision of the 1983 accord. The issues at stake were still wages and job flexibility and, above all the *Scala Mobile*, but this time Confindustria was taking a much tougher position and the unions reached the negotiating table without having achieved a joint position. The CISL and the UIL were favourable to further reductions in the *Scala Mobile*, while the CGIL made the reform of the system conditional on the government's commitment not to distribute the costs of further economic growth and employment exclusively among the working class. The situation was further complicated by the governmental leadership of Bettino Craxi, who sought to enhance the power of the executive in taking hard economic policy decisions (*decisionismo*) and by an even stronger opposition to the Communist Party. The atmosphere was so heated that in early February 1984, the communist and the socialist factions of the CGIL split, assuming different positions on the *Scala Mobile* and on the need to consult the workers before signing any agreement. This step slowed, if not prevented, CGIL participation in any compromise. On the 12th of February the Minister of Labour, Gianni De Michelis, presented a draft accord that maintained the trade off nature of the 1983 accord. It proposed a limitation of the number of

units to be paid every three months during 1984, but it also promised that the following year fiscal interventions would compensate any unforeseen losses in case higher inflation rates appeared. The CISL and the UIL promptly declared their willingness to conclude negotiations, while the CGIL, after a moment of hesitation, declared its unwillingness to accept it, thus joining the PCI in its negative assessment of the manoeuvre. Open conflict broke out between the government on one side, and the PCI and the communist component of the CGIL on the other side, when Craxi translated the basic terms of the 14 February protocol into a decree to be converted into law. Despite the campaign of the communists and their parliamentary allies, especially the deputies of the *Democrazia Proletaria*, and despite the massive popular demonstrations throughout Italy, this eventually happened on 12 June, 1984. In June the PCI decided to pursue a referendum on article 3 of the decree, which was the one that concerned the cuts to the *Scala Mobile*. By late September more than the required number of signatures had been submitted. On 7 December, 1984 the Central Office of the *Corte di Cassazione* declared the referendum constitutional. On the 9th and 10th of June, 1985, after a long and bitter referendum campaign had further complicated the administrative elections of 12 May, 1985, Italian voters finally defeated the PCI's efforts to overturn article 3 when 54.3 % voted 'no' and only 46.7 % voted 'yes' (Talani 2000).

The long battle over the *Scala Mobile* made it manifestly clear that the era of Italian political economy characterised by the market and political power of the union movement and by the PCI's ability to act as a political 'guarantor' of union cooperation with government policy had come to an end. The battle over the *Scala Mobile*, transcending its economic meaning, became a struggle over the balance of power within the different Italian sociopolitical and economic actors. The issue at stake was the control over the pattern of growth and distribution in the Italian political economy. With its conclusion, the basic contours of the political economy had fundamentally changed and the era of union centrality had ended with the labour movement and the PCI as net losers.

7.5 EMU, Job Market Restructuring and the 'Jobs Act'

The tendency of the Confindustria to approach the problems of labour costs through the mechanisms by which they are determined, starting from indexation, was confirmed by the following round of the battle over the *Scala Mobile* which led to its definitive abolishment with the 1993 agreement.

After a long controversy between the CGIL, CISL, UIL, Confindustria and the government, the latter had, with law No. 191 (13th July 1990) extended the *Scala Mobile* for the whole year 1991. However, from January 1992 the mechanism was again under the bargaining autonomy of the social partners. At the expiration of the deadline, the government confirmed, with the Protocol of December 1991, its firm decision not to allow any other extension by law of the *Scala Mobile* (Talani 2000). It indeed stated that all the problems relating to a new general system of bargaining and to the structure of retribution should be tackled by the 1, June 1992. The battle was likely to be extremely tough unless some external factor arose pressing the trade unions, or better the CGIL, to accept the agreement on wage policy as the only possible alternative to the abyss. This external factor was represented by the speculative attacks on the lira within the exchange rate mechanism of the European Monetary System.

This does not mean that the Italian economic elite provoked the speculative attacks, but the Italian employers' class certainly acted within the limits of the possible. Indeed, the Protocol eventually signed on 31 July, 1992 represented a major victory for the employers. The trade unions had agreed to the almost complete elimination of the *Scala Mobile* and had accepted that wage bargaining at plant level for the whole 1993 would be blocked in exchange for a forfeit sum of Lit. 20.000 (+$8) a month for all workers (Talani 2000).

The question of the structure of wage bargaining, not tackled in the Protocol, was left to further negotiations, leading to the agreement of 1993. The latter institutionalised the new balance of power between Italian social partners by introducing two levels of collective bargaining: the national and the plant levels. Moreover, it provided the launch pad

for future changes of social protection legislation, particularly reform of the pension system (Regini and Regalia 1997). Finally, it increased the level of flexibility of the Italian labour markets by improving the Italian training system (boosting internal flexibility) and legalising temporary work agencies (improving external flexibility) (Rhodes 1997: 14).

In the context of the decreasing bargaining power of the trade unions, some steps towards the deregulation of employment conditions had already been taken with Law 223/91 which modified the procedures of placement by introducing the so-called 'nominative call' in place of the 'compulsory call'. It also recognised collective dismissals as a possible solution for firms' crises, a measure which, together with the introduction of a new instrument of mobility insurance (a longer form of early retirement), was supposed to guarantee Italian companies the freedom to fire staff in case of necessity (Gualmini 1998). Coming to the hire side of liberalising policies, Law 223 abolished the obligation for firms to choose workers from the compulsory hiring lists (*liste di disoccupazione*) and introduced the principle of free choice.

In terms of job creation and labour market flexibility, a number of further initiatives were taken later, particularly by the Berlusconi governments, on the effectiveness of which, however, some doubts have been cast. Law 451/94 introduced the so-called 'public utility works'[12] which seemed to many yet another form of badly concealed *assistenzialismo* whose only outcome was to postpone the problem of unemployment for a very limited number of people. Moreover, some fiscal incentives for young employers starting new enterprises were introduced by the first Berlusconi government, as was a law on ad-interim jobs.

However, it was the second Berlusconi government, elected in May 2001, that would be the most active on the side of labour market flexibility.

On 3 October, 2001, the then-minister of Labour, Roberto Maroni, presented a white book on the labour market (*Libro Bianco sul mercato del lavoro*) containing a number of measures to render the Italian labour market more flexible.[13] On 15 November, 2001, the government pro-

[12] The law allowed public administrations and some private organizations to promote projects for works of public interest and to use long-term unemployed selected from the *liste di disoccupazione* for a limited period of time.

[13] For more information, see the web site of the Italian Labour Ministry at www.welfare.gov.it.

posed a draft law (the *Disegno di legge delega* Ddl 848) to delegate to the government the power to legislate on all issues relating to employment and the labour market.

After a long period of social struggle amongst the Italian socioeconomic groups, and after the murder of the father of the labour market reform, Professor Marco Biagi, the government and 39 employers' and employees' associations signed, on 5 July, 2002, the so-called Pact for Italy (*Patto per l'Italia*), declaring the necessity to adopt the law as soon as possible.[14] On 5 February, 2003 the Italian Parliament finally approved the Ddl 848 which became the Law n.30 on 14 February, 2003, also known as the Biagi law. The latter entered into force on 13 March, 2003. From that day onwards, the government has had the power to pass any laws regarding the reform of the labour market without having to go through the parliamentary procedure.

The content of this reform was clearly oriented towards a marked increase of the degree of liberalisation and flexibility of the labour market. It is, however, important to note that the overall rate of unemployment is not the only problem to be faced by Italian labour. More serious challenges arise from the pervasiveness of the black market and the great differences in terms of region, age and gender.[15]

In line with the tradition of using crisis in the EMU to foster liberalisation of the labour markets, the Renzi administration took the occasion of the Eurozone debt crisis to finally eliminate what remained of the 'Statuto dei lavoratori' of 1975. In particular, his aim, endorsed by the Italian Confindustria and actively promoted by the then leader of the organization, Squinzi, was to get rid of article 18 of the Statute, the one protecting workers from unfair dismissal.[16] With the so called 'Jobs Act', the new discipline of the Italian labour markets approved in December 2014, individual workers are protected against unfair dismissal only if

[14] For all the information relating to the pact and for the text see http://www.welfare.gov.it/NR/rdonlyres/ebuv5tvajrasify2koysjz3z7zola7h2zfbzogaiekkuoevsx2zavq22sftghelciyudq3m4vljpyh/20020905pattoitalia.pdf.

[15] For the related data see the Italian Statistical Institute (ISTAT) web site at the following address http://www.istat.it/.

[16] See La Repubblica 14 October, 2014 http://www.repubblica.it/economia/2014/10/04/news/squinzi_lavoro-97311900/as accessed on October 22, 2015.

such a dismissal is based on discrimination over race, gender, political or ideological grounds. In all other cases in which the judge declares the dismissal unjustified, the worker cannot be reinstated in his job position but will have only the right to some financial compensation. Thus, one of the pillars of the Italian labour protection legislation has been finally demolished.[17]

7.6 Conclusions

In conclusion, the neo-functionalist case automatically linking the establishment of the EMU to the flexibility of labour markets seems to conceal a number of power struggles amongst the different socioeconomic groups at both the national and the transnational levels.

Indeed, the implementation of an EU employment strategy relying significantly on labour market flexibility, the rationale of which is often neo-functionally linked to the establishment of the EMU, is certainly not the only possible approach to growth and employment, especially in the context of globalisation. On the contrary, it is interpreted here as the outcome of a series of political decisions taken by the member states within the context of the EU institutions and procedures. Furthermore, the implementation of flexible labour market policies was itself made possible by the strengthening of the bargaining power of employers' organisations which was reflected in the institutionalisation at the European level of the neo-liberal economic paradigm focusing on the implementation of strict monetary and fiscal policies.

Whereas the chapter clearly demonstrates that in the Italian case this power battle was certainly won by the leading socioeconomic actors, and this is reflected in the demise of the Unions' bargaining position, what the Italian capitalist elite failed to realise is that winning this battle against organised labour at the national level was not a solution to the problem of competitiveness in the globalisation era.

[17] See Il Foglio 19 October, 2015 http://www.ilfoglio.it/economia/2015/10/07/lavoro-contrattazione-squinzi-confindustria-renzi___1-v-133560-rubriche_c197.htm as accessed on 22 October 2015.

If it is true that the process of globalisation has modified the role of the nation state from the welfare model to the Anglo-Saxon model or 'competition state', it might be argued that the Italian capitalist elite failed to realise its project of transnationalisation and succumbed to the more powerful capitalist elites from outside Italy, those financial markets actively operating for the liberalisation of the Italian 'Salotto Buono'.

Of course, the Global financial crisis on one side and the asymmetries of the EMU on the other acted as catalysts for the weaknesses of the Italian capitalist system to appear clearly to financial markets and therefore unleash speculation.

Indeed, whereas the Italian capitalist elite only relied on 'Internal devaluation' and labour market flexibility to boost its competitiveness in a totally fixed exchange rate environment, this did not prove a successful strategy and produced a progressive peripheration not only of the country as a whole, but also, in particular, of its capitalist class.

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8

The Pros and Cons of 'de facto' Polish Opting-Out of the EMU

Serena Giusti and Lucia Tajoli

8.1 Introduction

When Poland freed itself from Soviet tutelage, it had to confront a complex multidimensional transformation including the transition from a planned economy to a market one. Tadeusz Mazowiecki, who in September 1989 led the first post-war non-communist government after partly free elections in June of that year, greatly contributed to the country's modernisation. The deeply indebted country was suffering from ranging hyperinflation and teetering on the brink of economic collapse while communist generals were still in charge of the army and the police and thousands of Soviet troops were stationed around Poland. In

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L.S. Talani (ed.), *Europe in Crisis*,
DOI 10.1057/978-1-137-57707-8_8

that difficult situation, Mazowiecki did not hesitate to approve a plan of extensive and radical reforms proposed by the Minister of Finance, Leszek Balcerowicz, who was advised by a bunch of liberal economists (among them Jeffrey Sachs).[1]

The reform package, endorsed by the International Monetary Fund (IMF), included a drastic reduction of the role of the state in the economy and the release of price-fixing for many products, allowing them to be set by the market instead of the Central Statistical Office. Also the internal debt was drastically limited, by approximately 3 % of GNP, by cutting state subsidies to coal, electricity and petroleum. The social consequences of the so-called 'shock therapy' were very dramatic, with about 1.1 million workers losing their jobs in the state-owned firms. Although inflation seemed to be out of control, the Polish economy gradually started to get back on track. By 1992, more than 600,000 private companies had been set up, providing jobs for approximately 1.5 million people. The shock-therapy economic reforms turned Poland into a market economy, the first that anyone had attempted, to reverse those wrought in the creation of a Marxist system. The return to power of the former communists in the 1993 parliamentary elections did not alter the country's commitment to both democracy and market economy. On the contrary, the alternation of political power was judged as a confirmation of democracy consolidation.

It is still debated if the Polish economy would have been performing as well as it is (Poland's annual growth rate between 1989 and 2000 was the highest of all post-Communist economies) without such an initial hard treatment. Other former Central and Eastern European countries (CEEC) opted for softer reforms resulting in quite oscillating economic outcomes. Given the different background conditions and economic traditions, any comparative deductions would be quite inaccurate.

In the pre-accession period all the CEEC benefitted from the European Union's (EU) membership perspective in terms of reforming paths and

[1] On the complex process of reforming see L. Balcerowicz, *Post-Communist Transition: Some Lessons*, London, the Institute of Economic Affairs, 2002; L. Balcerowicz, *Socialism, Capitalism, Transformation*, Budapest, Central European University, 1995.

Foreign Direct Investment (FDI) attractiveness. Once they joined the EU, their economies further improved. According to a Commission Report, the new CEEC members enjoyed a faster growth that allowed them to move from GDP per capita that was 40 % of the EU-15 average prior to enlargement to 52 % in 2008.[2] Among the factors that contributed to the economic growth in the region was the improvement of productivity due to FDI and the associated transfer of technology. Economic growth has been accompanied by structural reforms in the labour market. Within the first 10 years of Poland's presence in the EU, two million jobs have been created: members of all social groups, including half a million economically inactive people, have been employed. The economic growth has significantly improved the situation of the Polish people: in 2005–2012, the number of people at risk of poverty or social exclusion decreased by seven million, and 1.3 million people were lifted out of poverty. In the short run, the opening of Europe's labour markets also helped to smooth social tensions. A drop in the economically active population was offset by migrants' money transfers back home (in 2004–2013, money transfers amounted to approximately Polish Zloty (PLN) 145.2 billion16 Euro (EUR) 36 billion and were equivalent to 60 % of net EU budget transfers).

The total investment volume grew by 75 % in 2004–2013. Between 2009 and 2011, the cohesion policy funded 51.6 % of Poland's public investments. The EU funds have been used for the modernisation of the infrastructure system, for regional development (Poland being the most decentralized country in Central and Eastern Europe), and for the reduction of the income gap between new members of the European Union (EU) and long standing ones. So far Poland has received more from the EU budget than it has contributed to it. Since 2009 Poland has been the principal net beneficiary of the EU budget. Poland has also benefitted from having the largest internal market among the CEEC. The significant increases in domestic demand have safeguarded Poland from the worst effects of Europe's recent economic crisis. Poland is the only

[2] European Commission, *Five years of an enlarged EU—Economic achievements and challenges*, Communication COM(2009) 79 final.

economy in the EU not to have fallen into a recession during the years of economic turmoil in Europe (2008–2014 approximately). Not only has Poland outperformed all other European economies in recent years, but it has also distinguished itself from many other large emerging markets, like Russia, Brazil and Mexico.

The value of the EU's membership for Poland and the other CEEC has been proved also through counterfactual argumentations. In a document released by the Polish government it has been stated that if the country had not joined the EU, the GDP per capita in purchasing power standards would have been at the 2009 level, in other words, it would have been lower by 11 % relative to the EU-27 average. In 2013, the value of Polish exports would have been lower by PLN 164 billion (25 %) and capital expenditures would have been lower by PLN 36 billion (12 %) in 2013, and throughout the 2004–2013 period by PLN 200 billion (7.8 %). Finally, employment would have been lower by 10 %, and unemployment higher by almost 38 %. Along the same line, a study by Campos, Coricelli and Moretti was presented at the Royal Economic Society's 2014 annual conference.[3] The study examines data for each EU member to answer the question, 'what would levels of per capita income and labour productivity be if countries had not joined the EU when they did?' Among the findings: for the average country, average incomes would be 12 % lower if they had not joined—and annual rates would have been 1.2 % points lower. Denmark, Ireland, the UK, Portugal, Poland, Hungary, Estonia and Latvia have benefitted most from EU membership. According to the study, the role of financial development (that is, more financially developed countries growing significantly faster after EU membership) seems to have been fundamental in the economic boost of the better performing members of the EU.

[3] N. Campos, F. Coricelli and L. Moretti, "Economic Growth and Political Integration: Estimating the Benefits from Membership in the European Union Using Synthetic Counterfactual Methods", 2014, https://docs.google.com/viewer?a=v&pid=sites&srcid=ZGVmYXVsdGRvbWFpbnxtb3JldHRpbGd8Z3g6MjIyZjYyZTI1NGNlOWVmOQ

8.2 Poland and the EMU

The outstanding economic results achieved by Poland since the starting of its accession process to the EU should have induced the country to join the European Monetary Union (EMU) once the criteria had been fulfiled.[4] On the contrary Poland, unlike other countries joining the EU in 2004 (Slovenia joined the EMU in 2007, Cyprus and Malta in 2008, Slovakia in 2009, Estonia in 2011, Latvia in 2014 and Lithuania in 2015) persists in staying out. Although for the new member states there is no possibility to 'opting out', having committed to the full adoption of the *acquis communautaire*, no timetable has been fixed. There has been a tendency to a soft approach in consideration of a tension between the 'Maastricht' criteria for low inflation and limited budget deficits, and the need for transition economies for public investment.

Transition economies have generally experienced upward movements in their real exchange rates, resulting in higher inflation or nominal exchange-rate appreciation (or both) and these factors could be in conflict with the requirements for exchange-rate stability and low inflation for Euro membership. However, as Poland has economically performed very well, these impediments do not apply anymore. And yet Poland has not adopted the euro (a date has not yet been set), although its leadership has for the most part calibrated its economic policies with that target in mind. What then are the economic and political reasons for postponing the adoption of the euro?

[4] According to the EU membership criteria, future members must demonstrate the 'ability to take on the obligations of membership including adherence to the aims of political, economic and monetary union. They are expected to adopt the euro when ready to do so, not immediately upon accession. For a new member country there are detailed conditions, involving several stages: the current, pre-accession stage, during which the country must demonstrate irreversible progress towards a functioning market economy and competitiveness as well as sustainable macroeconomic stability; an intermediary phase following accession, in which the new member participates fully in the single market and demonstrates progress towards achieving the conditions necessary to adopt the euro; a minimum of two years of successful participation in the exchange-rate-mechanism; fulfilment of the criteria that apply to current members for the adoption of the single currency, including a budget deficit of less than 3 % of GDP, a debt ratio of less than 60 % of GDP, low inflation and interest rates close to the EU average; the essential condition is a sufficient degree of sustainable real convergence.

The decision to join a currency union is always a matter of evaluating the benefits and costs connected with such a move, as both are always present for every country. This evaluation is complex not only because it requires a forecasting exercise, but also because many of the involved costs and benefits are very hard to measure directly, and they are often very specific for each country.

The traditional economic theory on this matter generally considers a set of expected benefits and costs for a country joining a currency area. The first and most evident benefit is the elimination of transaction costs due to the change in currency when international transactions occur. These costs are non-negligible, and they are higher the more integrated in terms of trade and other economic transactions a country is with its potential currency partners.

The second benefit is related to the first, and it refers to the elimination of exchange rate risk and the reduction of uncertainty for firms having a high number of economic relations with foreign firms. In the case of Poland, these two potential benefits are certainly substantial, given that the country trades mostly with the Eurozone; it receives from the Eurozone the largest share of foreign direct investments and it also has a large number of financial transactions denominated in euros. By staying out of the Euro, Polish firms face a cost disadvantage compared to other firms within the Eurozone, as they pay higher transaction costs and they face an exchange rate risk for every international transaction.

The third potential benefit is related to the quality of monetary policy put in place. Joining a monetary union implies a complete loss in monetary policy autonomy at the national level, to replace it with a centralized monetary policy. This can provide some advantages, as a common central bank can have a very high degree of independence from the local policy decision, and because of its large scope, it can provide a more stable price level thanks to a better control of inflation and a better control and regulation of the monetary and financial market. This type of advantage might be less relevant for Poland because it had managed to keep its inflation under control, but a further integration of its banking system and its financial market with the EU markets could certainly be beneficial.

This last point is connected to what—as mentioned—is perceived as the main cost of a currency union, the loss of monetary independence. From an economic viewpoint, this is costly because it limits the instruments a country can use to face economic shocks and to correct losses in price competitiveness. The main costs can occur in the presence of so-called asymmetric shocks, adverse shocks that hit only some of the countries belonging to a monetary union, or a shock hitting everyone but producing different effects. In these cases, the appropriate policy response would be different for countries differently exposed or with different outcomes. But by definition, a monetary union can have only one monetary policy response, identical for all.

Therefore, for a country in a monetary union experiencing an asymmetric shock, the common policy response might be inappropriate, and the final outcome can be sub-optimal (or in extreme cases, completely adverse), producing a cost in terms of GDP loss. Another instrument used by countries to face adverse shocks and losses in competitiveness is often an exchange rate adjustment (policy-driven or induced by market adjustments). This is generally a costly type of reaction to shock, as it affects all international transactions, and in particular, the relative price of exports and imports, but it is often perceived as less painful than a domestic prices or wages correction. Within a currency union, this is another adjustment instrument that is lost. During the turbulent years of the recent international financial crisis, characterized by high uncertainty on the evolution of the economic outlook, many countries, including Poland, felt more comfortable being able to maneuver their monetary policy and exchange rate at their own discretion if needed, even if discretionary policy changes could bring about even higher volatility, as shown by some EU countries.

Looking at the economic outcomes in the past decade, it is difficult to say whether the National Market System (NMS) that joined the Euro performed better or worse than the countries that did not. On average, NMS that are also members of the Eurozone display a slightly higher convergence with EU28 than other NMS, as shown in Fig. 8.1.

As mentioned, in general the Polish economy performed well after the EU accession and during the crisis, especially in terms of GDP

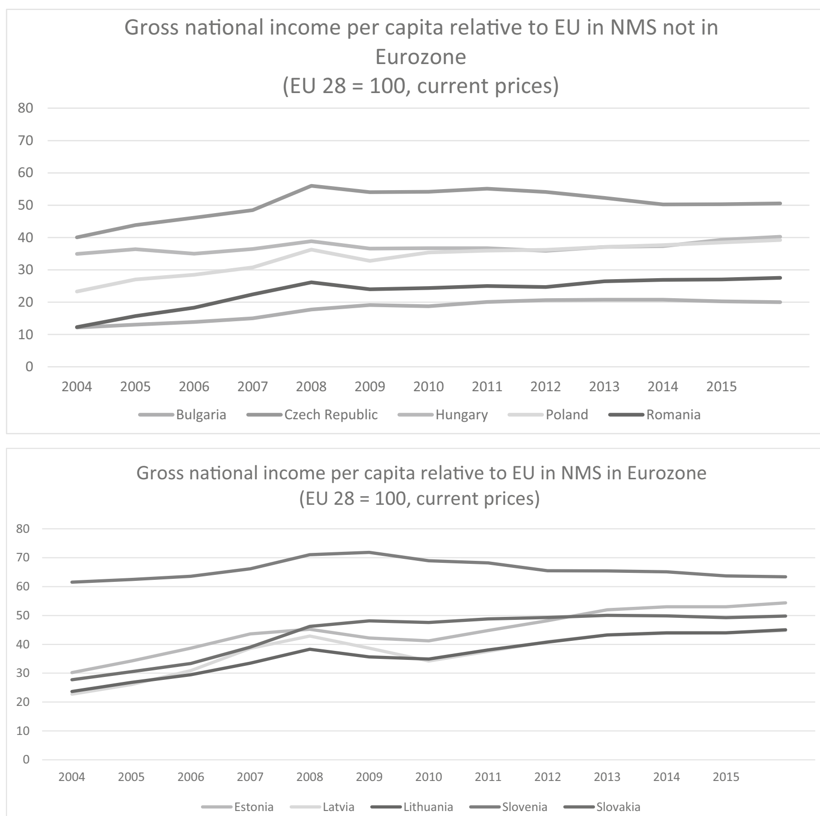

Fig. 8.1 Convergence in the European Union (*Source*: our elaboration on data from EU AMECO database)

growth rates. But its GDP growth rates since 2010 are not much different than the ones of Slovakia, which is in the Eurozone, as shown in Fig. 8.2.

Figures 8.3 and 8.4 show instead that Eurozone countries, including NMS, generally performed better in terms of inflation rates and balance of the current account.

It is very difficult to determine when the potential benefits offset the potential losses, but economic theory suggests the final balance is more likely to be positive through the so-called 'optimal currency area' (OCA)

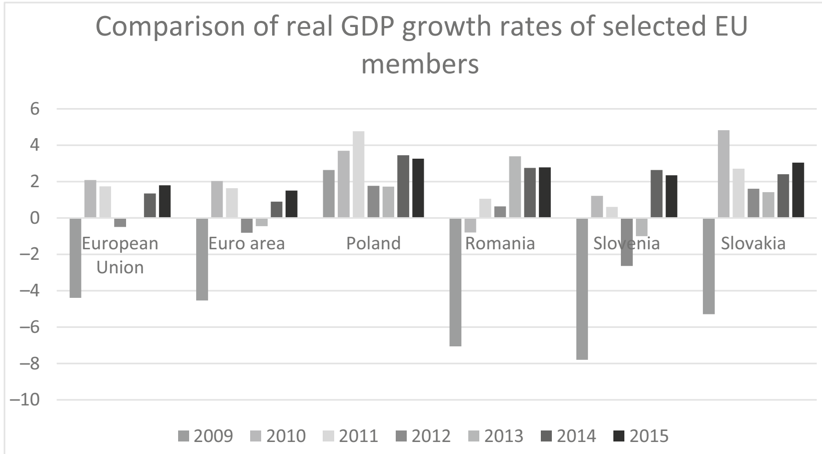

Fig. 8.2 GDP growth rates in Poland and the EU after the crisis (*Source*: our elaboration on data from EU AMECO database)

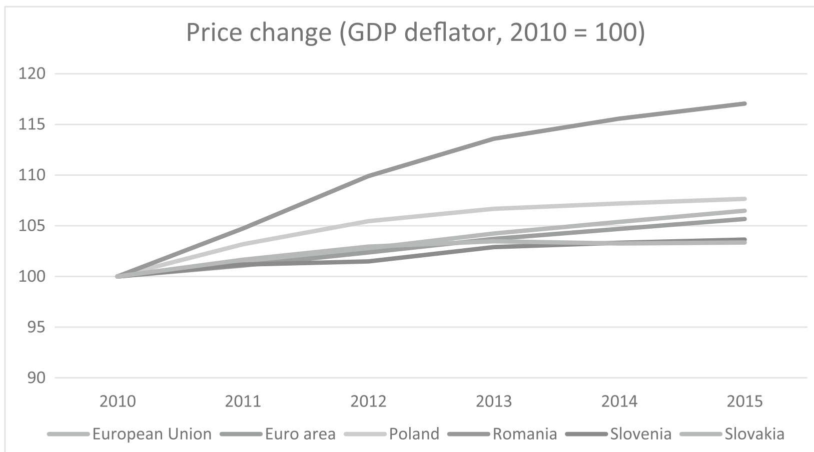

Fig. 8.3 Inflation in Poland and the EU after the crisis (*Source*: our elaboration on data from EU AMECO database)

criteria. These criteria basically define under which conditions the likelihood of asymmetric shocks is minimized, or the possibility to react to them with different tools exists and would reduce the potential costs of joining a monetary union and allowing the benefits to prevail.

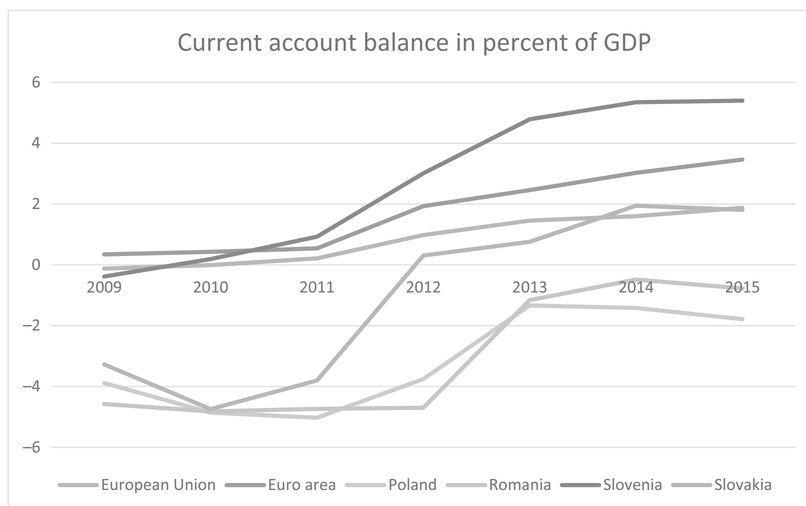

Fig. 8.4 Current account balance for Poland and the EU after the crisis (*Source*: our elaboration on data from EU AMECO database)

The first criterion is high mobility of factors of production (labor and capital) between the countries belonging to a monetary union, so that a movement of these factors from one country to another could offset the negative consequences of an asymmetric shock. It is generally believed that while firms and capital are quite mobile across Europe, labor mobility within the EU is insufficient in practice to meet this criterion, in spite of the formal freedom of movement of workers. Workers' mobility from the NMS has been higher than in the rest of the EU, even if these countries did not experience the huge migration waves feared before the accession, confirming that many barriers (from different languages to different social security systems) still hinder labor mobility within the EU. Poland experienced a fairly large emigration effect after the accession to the EU, and the estimates of the Polish Statistical Office state that over two million Polish workers have moved abroad since 2004. In this respect, Poland seems to meet better than others the first OCA criterion, but asymmetries in mobility across Eurozone countries make it difficult to assess how effective this can be to smooth possible problems.

A second criterion, connected to this first, considers the degree of openness and integration of the countries belonging to the currency area. If these are high, and markets work well, the forces of supply and demand could distribute money and goods where they are needed in case of asymmetric shocks. Poland fares well with this criterion, as it has a high integration with the EU, and especially with Germany. Being the largest economy of the group, this deeply affects the economic outlook of Europe. Poland fares less well in terms of market flexibility, but it is not very different from other Eurozone countries.

A third criterion looks at the industry composition of the economies. Countries with a higher diversification in production are more likely to cope well within a monetary union, as they are less exposed to asymmetric (sectoral) shocks. In this respect, Poland seems well fit, and the composition of its economy does not seem an important reason not to join the Eurozone. It should be stressed that the economic structure of former transition economies is still different from the EU average in many respects, and the possibility of asymmetric shocks cannot be ruled out.

Overall, in economic terms, Poland does not seem less fit to join the Eurozone than other Central and Eastern European countries that made a different choice. Certainly, the much larger size of the Polish economy, compared to the ones of the Baltic states or of Slovakia and Slovenia, gives to the country less flexibility that can make it more costly to lose additional degrees of freedom. But the economic arguments against joining the Euro, considered at the country level and looking at other Euro members are not very strong.

Furthermore, these criteria should be treated as endogenous, as suggested by Frankel and Rose.[5] In fact, a country's economy is very likely to change after joining a currency union; to become more open and integrated, with more flexibility in its markets, to eventually better meet the optimality criteria with time after the membership. The main economic reason from the point of view of Poland for not joining seems to have been the willingness to preserve enough flexibility to maintain a positive

[5] Frankel J. A. and A. K. Rose, "Endogeneity of the Optimum Currency Area criteria", *Economic Journal*, Vol. 108, no. 449, July 1998, pp. 1009–1025.

outlook and put in place policies to foster convergence with the rest of the EU. If convergence is the ultimate goal, it is debatable whether this is accelerated or slowed down by the Euro, even if joining the Euro will certainly limit the use of some economic policies.

Another key criterion for an OCA is not set at the country level, but it considers what needs to be done if a shock hits a currency area to better cope with it and share the risk. What is suggested is the creation of a risk sharing system such as an automatic fiscal transfer mechanism to redistribute money to areas or sectors which have been adversely affected. It was very clear that the Eurozone badly lacked such a mechanism when the international financial crisis hit a few years ago, and therefore countries that had not joined at that moment thought they probably did the correct thing. But this situation is also changing, and the EU started to set up a sort of emergency mechanism precisely because of the crisis, and it is now better fulfiling this criterion, possibly reducing the potential costs of membership.

According to Marek Belka (former Polish prime minister and President of the National Bank of Poland),[6] the good performance of the Polish economy during the crisis did not make the prospect of joining the Euro area any closer. On the contrary, it is difficult to foresee Poland's integration with the Eurozone now that the general impression in the country is that this would make it more difficult to preserve the positive tendencies, which will foster real and nominal convergence of the Polish economy. However, Belka also stresses the processes taking place in the Eurozone and the reforms set in place to stop the divergence process that the crisis stirred up; reforms that will make the Eurozone different than it was prior to the crisis. Therefore, according to him, the best recipe for Poland as an accessing country is to wait, and in the meantime to make every possible effort to enhance its ability to meet entrance criteria in a sustainable way and to observe processes taking place in the Eurozone.

[6] http://www.financialobserver.eu/poland/poland%E2%80%99s-eurozone-tests/

8.3 What Else?

There are also other kinds of impediments making the adoption of the euro not a very feasible option at the moment. In order to enter the Eurozone, a change in the Polish Constitution that must be approved by a two-thirds majority in parliament is required. Opinion polls show that the majority of voters are not in favour of the adoption of the euro. The political élite has tended to say that entering the Euro would be risky for Poland as it could boost speculation in the highly liquid zloty, and could push up prices of consumer goods. Poland has determined that having its own, free-floating currency can be profitable at a time of a severe economic crisis. Referring to the dramatic situation in Greece, the politicians have remarked that the Maastricht criteria might be inadequate and risky, being established in a completely different economic context. The exploitation of the economic crisis affecting the Euro Area does not seem sufficient to explain the country's reticence towards the common currency. Why is Poland recalcitrant on monetary integration, although it has been among the frontrunners in the process of European integration?

Poland's relationship with the European Community/European Union (EC/EU) has been marked by a strong attractiveness and assertiveness. Both attitudes have their roots in the troubled history of the country, sandwiched between Germany and Russia.[7] Despite a fragile statehood due to the frequent various partitions suffered, Poland has developed a strong political identity. Once Poland succeed in gaining full autonomy from Moscow in 1989, it immediately looked westwards to cut off the Soviet legacy. The country's priority became to join the Euro-Atlantic community and to become a 'normal' European country. The wide use in political discourse of that time of the 'returning to Europe' metaphor explains the country's determination to reconnect to the Western-European mainstream.[8]

[7] On the politics of memory see M. Killingsworth, M. Klatt, S. Auer, "Where Does Poland Fit in Europe? How Political Memory influences Polish MEP's Perceptions of Poland place in Europe", *Perspectives on European Politics and Society, Vol. 11, No. 4, 358–375, December 2010….*

[8] The central theme of 1989-revolutions and post-Communist changes is grasped by the metaphor of 'returning to Europe'. Ash noted that "In all the lands, the phrase people use to sum up what is

Poland and the CEEC opted for a democratic system and a market economy without embarking on any third-way experimentation (socialism and capitalism). CEEC political elites were constrained by the existing institutional architecture and by the shortage of political and economic resources for building up new institutions. The Euro-Atlantic alliance offered an attractive package, combining the market economy's material prosperity with liberal democracy's heritage of political freedom and security.[9] In particular the aim of 'matching up to the market' determined both content and pace of the whole transformation process that in fact overlapped with that of Europeanisation.

After all, the fact that convergence on the Western model and institutional setting was a good choice was corroborated by a self-evident argument: the Euro-Atlantic system had survived the Cold War almost intact as the undisputed winner, while the Soviet system had crumbled. Moreover, by imposing tight economic and political conditions in exchange for material incentives, international organisations (the World Bank, IMF, and EU) consistently orientated reforms in CEEC and made the EU choice even more likely. In a sense, they helped to make the path of European integration inevitable for the CEEC. Already in 1999 Poland succeeded in joining NATO and, five years later, the EU.

The accession negotiations with Brussels revealed the Polish leadership's determination to maximize national interests in the European context. As a new member of the EU, Poland has worked hard to influence the decision making process and to become a prominent country, aspiring also to be a leading regional power (in particular within the Visegrad group).[10]

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happening is the return to Europe". See T.G. ASH, *We the People; The Revolution of 89*, Cambridge 1990, p. 3.

[9] The collapse of communism in the East was concomitant with the affirmation of a global liberal capitalism 'ideology' in the West and the decline of political passions. As Furet put it "we live in a closed political universe". F. Furet, *Europe after Utopianism*, in *Journal of Democracy*, Vol. 6, January 1995, 1, p. 80. Hankiss underlined that Central and Eastern Europe countries were obsessed with the "*nevrose de l'arriétation* E. Hankiss, *European Paradigms: East and West, 1945–199*", in *Daedalus*, Vol. 123, Summer 1994, 3, pp. 115–126.

[10] Created in 1992, the Visegrad, composed of Poland, Hungary, the Czech Republic and Slovakia, is perhaps the most frequently referenced framework of cooperation when reading about Poland's regional groupings. This initiative tries to promote cooperation through mutual contacts at all levels: from high-level political summits to diplomatic and experts meeting, to individuals, think tanks, research centers and regional Non-Governmental Organization (NGO) activities.

Many factors—a sustained economic growth, a credible leadership, the capacity to build up strategic alliances within and outside the EU—have contributed to strengthen Poland's position in the EU. The Polish leadership has been very active in shaping the EU's foreign policy. Poland has supported the European Neighbourhood Policy and has, together with Sweden, promoted the Eastern Partnership, a policy launched in 2009 dedicated to strengthening relations with the post-Soviet states of Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine.

The successful management of the EU's Presidency (second semester 2011) further reinforced polish influence. The Polish presidency had to confront the implementation of all the novelties introduced by the Lisbon Treaty. The crisis in Europe did not allow it to carry out significant changes, but certain actions leading to establishing rules for cooperation between various institutions are to be positively assessed. Poland has been also successful in conquering important roles in the EU institutions as the appointment of former Prime Minister, Donald Tusk, as a European Council President, also in charge to chair Eurogroup summits, demonstrates. Negotiations of the Multiannual Financial Framework for 2014–2020, a key to Poland's long-term development prospects, have been one of the country's most important and hardest-won political achievements in recent years.

The Polish leadership capacity to stand out in the EU has not fundamentally reconverted Polish people to the initial EU-enthusiasm. The process of European integration has been, since its inception, widely supported by Polish society although there is a decreasing consensus in public opinion. This is due to the development of a less idealistic vision of the EU and the social costs linked to reforms for the modernisation of the country which have been presented as the price for membership. In the pre-accession period, integration was discussed primarily in terms of values with frequent recalls to historic justice.[11]

The starting of the accession negotiations favoured a more realistic understanding of the EU. The membership was frequently assessed not simply for its symbolic significance but also in terms of costs and benefits. This more rational attitude brought a certain disenchantment and a pro-

[11] P. Cichocki, *Polish Attitudes towards the EU*, Przeglad Zachodni 3, 2011.

gressive detachment from the EU. This phenomenon was quite common for the rest of the CEEC. It dramatically manifested in the occasion of the referenda held on the EU accession in which high support for membership came on the back of low participation rates. In Poland, where the turnout had to reach 50 % for the result to be valid, the turnout was the highest while in Hungary it was below 50 %.

One of the consequences of the accession to the EU has been the deterioration of the so-called bipartisanship. The prospect of membership often helped parties in the CEEC to reach a consensus on issues of domestic policy (bipartisan alliances), accelerating reforms and guaranteeing a certain stability. Before accession, political tensions due to hard economic reforms generally tended to be voiced trough alternation in power in a way that did not challenge the consensus over EU membership. No matter who was in power, the project of European integration was considered a common and vital objective for the country. Former Polish Prime Minister, Buzek, for instance affirmed that his country's admission to the EU was a 'great national task' that should be pursued jointly by the government and the opposition.[12]

As these countries joined the EU in 2004, their party system became more divided and polarised. In particular, bipartisan positions typical of the pre-adhesion period vanished. If before accession the EU membership was a top priority for the whole society, then opposing Brussels turned into a sign of state strength and national identity. In Poland, a critical attitude towards the EU started to affirm making the country more intransigent than in the pre-accession period and hardly inclined to compromise. Political elites have been less committed to the European project and openly contrast EU decisions where they do not coincide with national priorities (i.e., the adoption of the euro, the curbing of coal-fired emissions, the redistribution of the refugees quota). This attitude is mainly evident in foreign policy where Poland does not feel entrapped by European decisions and freely pursues its national interests, often preferring bilateralism to multilateralism (e.g., the Polish veto on the opening of the negotiations for the renewal of the EU-Russia Partnership and

[12] Likewise, the Polish largest opposition party, the Democratic Left Alliance, pledged co-operation in speeding up the approval of EU-related laws, RFE/RL, February 17, 2000.

Cooperation Agreement as a reaction to Russia’s embargo on its meat exports).

Although there is a mounting anti-EU political rhetoric, the permanence of the country in the EU has never been disputed. Euroscepticism has been traditionally the preserve of the conservative Law and Justice party (PiS), and of its leader, Jarosław Kaczynski who is notably opposing any proposal for the creation of a European federation. Before Poland became a member of the EU, Kaczynski strongly supported it’s country adhesion to the organisation. When Kaczynski’s party won power in 2005, he did not alter his rhetoric, even advocating the creation of a European army. However, in order to calm the extremely conservative part of his party’s electorate, his anti-European coalition partners, the League of Polish Families and Father Tadeusz Rydzyk, the head of the ultra-conservative Catholic radio station Radio Maryja, he usually added to his slogan ‘Poland in Europe’ the words ‘as an independent country’. The PiS in fact has absorbed those voters who formerly supported the League of Polish Families (LPR)—the only party the majority of whose supporters declared an unfavourable attitude towards European integration. As a result of the League’s election failure, since 2007 Eurosceptical voters were without parliamentary representation. Consequently, extreme positions on the EU have been curbed.

So far, in Poland Euroscepticism has manifested especially in the low voter turnout in the EU parliamentary elections. In 2004 in Poland the turnout in the elections to the European Parliament was 20.8 %, which was one of the lowest in the entire Union; the overall percentage of EU citizens who cast a ballot was 46 %. Hence, the low turnout in Poland reflected the general European trend showing that public opinion has lost interest in European Parliament elections. In 2009, in turn, the turnout was 24.5 %, which was slightly better than the previous one; however, still one of the worst results in the entire EU and in 2014 the turnout decreased again reaching 23.8 %.[13]

The return of the PiS to power after the Civic Platform (PO) governed Poland for the last eight years, secured by the election of Andrzej

[13] For the data on the turnout see EP, http://www.europarl.europa.eu/elections2014-results/en/turnout.html

Duda as a new President (May 2015) and the victory of the parliamentary election with more than a third of the vote (October 2015) by the PiS's candidate, Beata Szydło, might reinforce anti-EU sentiments. Certainly it puts at serious risk the adoption of the euro in the short/medium term. During the electoral campaign, the PiS has pledged a rise in public spending and a larger state role in the economy. It has also called the central bank to launch a cheap lending programme worth 350bn złoty over six years to support growth—an idea that some see as undermining the bank's independence, thus making it more difficult to comply with the Maastricht criteria. PiS has received the support of a large part of Polish society, in particular Catholic, conservative inhabitants of the eastern and south-east part of the country. All these people feel they have not benefited from the transition to market democracy and still fear economic and social liberalism including probably adherence to the common currency.

The 2008 financial crisis with its lasting effects has not helped the Polish political elite to channel a positive image of the EU. In 2010, the Eurozone's debt crisis caused a declining interest for the Euro with nearly half of the population against it.[14] In March 2011, research by Centre for Public Opinion Research (CBOS) showed that 60 % of Poles were against adopting the euro while 32 % were supportive, a decrease from 41 % in April 2010.[15] Surveys in the first half of 2012 indicated that 60 % of Poles were against the adoption of the Euro.[16] Public support for the common currency continued to plummet, reaching record lows in the CBOS polls from July 2012, where only 25 % of those polled supported a switch to the euro.[17] A later poll for the German Marshall Fund published in September 2012, even found 71 % of Poles believed an immediate switch to the

[14] "Czechs, Poles cooler to euro as they watch debt crisis", Reuters. 16 June 2010.

[15] CBOS, 28 March 2011.

[16] *Wirtualna Polska*, 14 February 2012.

[17] CBOS, 27 July 2012. 27 July 2012.

euro would be bad for the Polish economy. According to a standard Eurobarometer poll in April 2015, 44 % of Polish people were in favour of introducing the euro (a decrease of 1 % from 2014) while 53 % were opposed (no change from 2014).[18]

Polish citizens are not only negatively affected by the economic crisis suffered by the Eurozone countries but also by other kinds of crisis (e.g. Ukraine, Syria, refugees). Furthermore, the EU is increasingly and profoundly divided on how to confront all these crises. This fragmentation is not helping the creation of a favourable public opinion climate towards the Euro. Problems already familiar in Western Europe, such as the lack of legitimacy and trust in the EU institutions, tend to emerge in Poland and in the other CEEC. As the October 2015 parliamentary election has shown, Euro scepticism tends to blend with populism.

Before the 2015 political cycle, some other strategic considerations were coming to the fore when debating on the Euro, such as the fact that the adoption of the common currency could make Poland acquire a stronger leverage on the European economic issues while reinforcing its regional/international prestige. Central bank Governor, Marek Belka, suggested, for instance, that Poland should reconsider its reluctance towards Euro membership because of security concerns sparked by the conflict across the border, referring in particular to the Ukraine crisis that has *de facto* turned into a frozen conflict. What Belka was trying to do was to convince his citizens and some political factions that although the economic benefits derived from joining the EMU might be modest, the political rewards could be particularly attractive. Within the EU, if Poland became part of the EMU circle, its leverage on other salient and strategic topics such as defence, foreign policy and energy would be important. In other words, the Euro could become a multiplier of power.

[18] http://ec.europa.eu/public_opinion/flash/fl_400_en.pd and http://ec.europa.eu/public_opinion/flash/fl_418_en.pdf

8.4 Final Remarks

As we have argued, the Polish economy has performed well after the EU accession and during the crisis, especially in terms of GDP growth rates. But its GDP growth rates since 2010 are not much different than the ones of Slovakia, a country that belongs to the Eurozone. The countries which have adopted the Euro, including NMS had generally good results in terms of inflation rates and balance of the current account. The fact that Poland was the only EU nation to avoid recession and that it remains one of Europe's fastest growing economies has not made the prospect of joining the Euro Area any closer. On the contrary, it is difficult to foresee Poland's integration with the Eurozone now that the general impression in the country is that this would make it more difficult to preserve the positive tendencies, which will foster real and nominal convergence of Polish economy.

Besides, the current political phase with a President and a Prime Minister of the same conservative party (PiS has scored the biggest victory for a single party in terms of seats since Poland shed communism in 1989) is not propitious for the Euro adoption. Although the PiS has not announced any drastic choice such as an exit from the EU, its overall position on the European integration process is quite critical and minimalist. The prospected economic measures, in particular the increase of the social spending, are not compatible with a rapid accession to the Eurozone. The adoption of the common currency is not at the moment contemplated in the PiS political agenda while the public opinion climate remains hostile. People perceived that entering the EMU had more costs than benefits. Additionally, Civic Platform was not smart at selling economic advantages while PiS was very clever in tapping into persistent discontent.

In addition, the very essence of the European integration process is being contested even for its normative implications. On one hand, the economic crisis has turned Poland into a strong and credible EU member, in principle well suited for a role of a leading country within the EU. On the other hand, Poland is willing to keep its involvement at the minimum not approving some of the EU's positions. The deepening of internal divisions within the EU and the recent confrontation with

Russia over Ukraine are likely to corroborate Poland's unenthusiastic standpoint on the EU.

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9

Conclusion: Out of the Present European Crisis: Questions and Alternatives

Pascal Petit

In this concluding chapter we want to stress first that the 2008 global financial crisis occurred at a very challenging time for the European Union (EU) as it was trying to find a new balance after its enlargement and the relative failure of its 2000 Lisbon Strategy, retained at the time to adjust to an increasing international competition fuelled by the globalisation of finance. Second, the 2008 crisis made it clear that what we can call the EU method of regional integration, a defensive process which had for decades been very lengthy, had been deeply transformed, if not hollowed out, along the two decades of neo-liberal economics dogma where the motto was to flexibilise labour markets and put the adjustment pressure on wages. Each chapter of the book exposes the depressing features of such petering out of the EU dynamics of integration. The Greek crisis in this context appears as the most revealing of this decline, considering the little weight of this economy in the whole EU GDP and its symbolic importance as the historical centre of the European civilisa-

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L.S. Talani (ed.), *Europe in Crisis*,
DOI 10.1057/978-1-137-57707-8_9

tion. The reasons behind the recurring collapse of the negotiations on the Greece adjustment program point at rigidities of unexpected magnitudes on the sides of both the EU and Greece.

However, one should not conclude from this specific, though highly symbolic case, that we are witnessing a deadly crisis of the EU. Ways out of this crisis will certainly be painful but they do exist. In the first place, rather standard actions can be taken that would ease political solutions to follow. Sizeable, well targeted investment schemes could do the job without being of an unconceivable magnitude, as a straightforward simple calibration exercise can show. At minimum they would set the European economies on recovery tracks and therefore re-open the debate around political solutions for a brighter future. A major factor to update the political agendas and reset on a totally new path the EU method of integration can actually be given/enforced by the current environmental challenge.

The climate change is bound to worsen and to have increasing detrimental effects, stressing the emergency to act at various levels in coordinated ways which goes far beyond what market forces can achieve. The re-legitimation of collective actions that is bound to follow will give the opportunity for a comprehensive renaissance of the EU integration process in order for the EU to become both a major global actor on such global issues and a strong centre of support for collective local actions that meet the new norms edicted to adjust to the environmental challenge. The big issue remains whether or not the EU will be able to make such an update of its integration process rapidly enough.

9.1 A Global Financial Crisis that Hit the EU at a Critical Time

The financial crisis occurred as somewhat of a surprise to Europe. Certainly warnings of the dangerous exuberance of the financial world had been issued many times since the financial crisis of the turn of the century and the financial innovations that diffused afterwards. Not only Robert Shiller had stressed in the mid 2000s[1] the risks that speculative

[1] If only in the second edition in 2005 of his book “Irrational exuberance”.

bubbles spread all around financial places but even Bernanke, at the time director of the US Federal Reserve, echoed these worries. But Europe had at the time an agenda already too full to give full notice to these warnings coming from the other side of the Atlantic. EU officials strongly underestimated the level reached over recent years by the globalisation of finance.

So the collapse of the Lehman Brothers Enterprise, and the rapidly ensuing set of large banking institutions risking bankruptcies while revealing this unprecedented level of globalisation of finance, soon became a major challenge to EU member states. Clearly the wave of near-bankruptcies was crossing the Atlantic and European financial institutions were trapped in the collateral damages of the failure of large US financial institutions. Shadow banking, internal transactions between banks, had spread the risks all over the occidental world, Asia being less concerned as its financial institutions had retained the lessons from the 1997 crisis and therefore responded more cautiously to the global diffusion of innovative financial instruments in the early 2000s. The challenge was mainly for the nation states and the response to this global financial issue came first from the G7, leaving a secondary role to the EU which had not foreseen the coming blow and had not taken any steps to protect its members from these speculative trends. This shortsightedness was all the more damaging for the EU in that the shock was asymmetric and bound to harm some member states more than others and therefore require strong actions to preserve the cohesion within the EU. This was all the more imperative and difficult to achieve as the EU was just completing a major enlargement to the East with countries that had freshly transitioned from socialist to capitalist systems and had de facto little experience of the specificities of the EU dynamics and a strong, even if formal, commitment to market economy.[2]

It was difficult under these circumstances to hope that the EU member states could come overnight to any agreement on a common stand on how to deal with the risks bearing on finance institutions. Nation states themselves seemed a bit lost, considering the magnitude of the possible collapse of major banking institutions and, before implementing mas-

[2] The differences between old and new members thus come out quite clearly in the analysis of wage dynamics in Chap. 4.

sive bailing outs, rumours of rather comprehensive nationalisations were heard of, very surprisingly after two decades of diffusion of an ideology of neo-liberal economics strongly criticising public enterprises.

Still the enlargement was not the only big affair of the EU in the mid 2000s. It was also the time when the strategy retained by the EU in Lisbon in 2000 to meet the challenge of a new world, open to an increasing external and innovative competition, was turning out to be a relative failure (on the Lisbon agenda, see Chap. 3). The ambition of this strategy 'for the EU to become the leading knowledge based economy in the world' was not only grossly exaggerated but chiefly revealed a deep misunderstanding of this new coming world where the mobility of knowledge and specifically the mobility of the development of innovations could not ensure that the rents of innovation would be located in the most developed economies with the major education and research institutions. The catching up of emerging economies quicker than expected, fiscal optimisation of large multinational firms as well as global intermediations (from Wall Mart to Booking.com, Amazon or Google) all concurred to marginalise the impact of the Lisbon strategy. The revision of this Lisbon strategy in 2005 clearly assessed its relative failure. Its poor achievement in terms of employment was the major criticism that came out of this assessment. No in depth revision of the strategy was attempted that would have warned of the dangers of fiscal evasion, of financial speculative runs or of the development of monopolistic situations at a time when global value chains, financial innovations and e-networks were strongly diffusing across the world.[3] This was all the more disappointing as the Lisbon strategy, despite its pretentious claim, was a defensive step. At the turn of the century, Europe was just experiencing the collateral damage of the globalisation of finance with the 1997 East Asia financial crisis. It was then made clear that rumours and panicking rushes on Wall Street could be harmful miles away in places where the local situations did not deserve such overreactions of the financial system. Moreover, the ups and downs of the stocks of dot.com enterprises that preceded the 2001 dot.com cri-

[3] One will have to wait until the Europe 2020 strategy to see a more encompassing approach of competitiveness (see Chap. 3), still falling short of what would be required to face fiscal evasion, oligopolistic captures of markets or abusive rents of intellectual property rights.

sis all warned of a deep transformation in the world of business to which the Lisbon agenda planned to respond. The 2005 revision did not lead to any consistent updating of this defensive strategy. To this intrinsically weak position of the EU in the mid 2000s embarking on a broad enlargement and feebly responding to the new state of international business more and more geared by financial criteria, one should add the fact that the experience of the euro, although planned long in advance, was still only starting. Launched fully in only 2000 with the distribution of bank notes, it appeared in a world where the supremacy of the US dollar seemed threatened by the huge external deficit of the USA as a strong currency, leading to speculative runs and very unstable exchange markets. In a still diverse EU, even among Eurozone members, the strong appreciation of the euro, provoked by a mistrust in the dollar, implied for some countries of the Eurozone an overvaluation and for others an undervaluation. Such misalignment of real exchange rates (see Mazier and Petit 2013) turned into a major factor of divergence in a subset of countries which looked in the first place to increase their convergence in order to improve their cohesion. Once again the move towards the euro ended as a rather defensive step in the EU integration process. If the idea might have, in the early 1990s, looked like a progressive step of integration of the core countries of the EU, it had become by the end of the 1990s, once the liberalisation of finance had led to highly speculative currencies markets, a defensive move to avoid the dividing effects of speculative runs against the weakest currencies. In the second half of the 1990s, many EU countries were indeed protecting their currencies by tying them to the German mark, which had become the strongest currency of the EU countries (despite the difficulties of the reunification). The rush for the euro, once the external situation had changed over the 1990s thanks to the diffusion of the neo-liberal economics ideology, had definitely become a defensive move. Clearly, for all the above reasons the 2008 global financial crisis occurred at a very bad time for the EU, one of the worst over its half a century long experience. Still the damages that followed cannot be explained if one does not also take into account the progressive change in the very method of EU integration that occurred from the 1980s onwards with the diffusion of the neo-liberal economic dogma that gave full priority to market mechanisms over any public intervention.

9.2 The European Method of Regional Integration: A Lengthy Defensive Process Progressively Hollowed Out

9.2.1 A Defensive Strategy from the Beginning

The project of the European Union was in a way defensive from the start. It clearly manifested the will of European countries to put an end to a continuous series of increasingly devastating wars. It was conceived as a progressive, attractive project clearly at the opposite of a militarist or mercantilist alliance to conquer the world. It gained on this basis a large support from populations which had suffered from the second world war; it even appeared as a factor boosting the development of social welfare in member states. But we shall come back to this 'offensive' side which clearly inspired the earlier steps of the EU but were little formalized in the process. The defensive central side of the project was first materialised with the creation in 1951 of the ECSC (European Coal and Steel Community) which clearly aimed at preventing any hidden attempt to rearm.[4] The Euratom treaty signed in 1957 was clearly based on the same objective. The Treaty of Rome signed in 1957 to be implemented from 1 January, 1958 onwards was in a way broader in its scope: 'The Community shall have as its task, by establishing a common market and progressively approximating the economic policies of Member States, to promote throughout the Community a harmonious development of economic activities, a continuous and balanced expansion, an increase in stability, an accelerated raising of the standard of living and closer relations between the States belonging to it'.[5] The objective was clearly not a common market with mercantilist objectives. The establishment of the common market started with the removal of duties between member states and the ongoing process of its completion was to ensure the four freedoms: mobility of goods, the mobility of persons, and the establishment of rights for persons and capitals. Clearly these internal objectives

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[4] Let us notice that this ECSC creation included the creation of a Court of Justice.

[5] Article 2 of the treaty of Rome.

have never been fully completed, especially regarding the mobility of persons and their right to work in any member states, as shown when the 2004 enlargement occurred. Less openly assessed but of a growing importance were the external objectives of the union, clearly defensive. To begin with, in the reconstruction period of sustained growth, the creation of the EU as a unifying economic community was clearly a way to balance the economic power of the USA which had played a great role with the Marshall plan but which represented a threat to an autonomous development of the European countries with the economic power of the US multinational enterprises. There was also a need to turn away, in coordinated ways, from the special relations that some European countries entertained with their colonies at a time when the independence of these colonies was bound to happen, if only supported by US diplomacy. The organisation of a rather protectionist Common Agricultural Policy (CAP) was a major example of such an arrangement, duplicating somehow the dualism of the US free trade policy with the status of exception in the trade of agricultural products. There is no need to add that the common market was also a defensive act to counter the political influence of the socialist bloc. Progressively this process of economic integration constituted the EU as a major global player. Clearly this overview of the process of European integration supports its qualification as a defensive project. It is again this role that the EU is following in the current negotiations of the transatlantic treaty (TTIP) offensively supported at its beginning by the USA to contain the rising influence of China over world governance. It is likely to be the posture of the EU in dealing with the challenge of the migration flows coming from the refugees of the Middle East. Let us notice that only in the field of environment preservation had the EU had what could be positively qualified as an offensive role when it allied with the UN to launch the Kyoto protocol. We shall come back to this point in our last section. The aforementioned development on the long defensive stand of the process of EU integration where countries had rallied at various stages until 2004, enlarging the EU from 6 to 28 members, does not imply, though, that this process has remained unchanged for the five decades from 1958 till 2008. It is, on the contrary, very telling of the dynamics of the EU and of its very nature to take a closer look to what we can call the EU method of integration.

9.2.2 The EU Method of Integration

The story of the successive treaties does not say on which basis and how they were negotiated. One can simply notice that these treaties were many and that until recently they did not involve directly the peoples of Europe. The process was not directly democratic in that sense, even if it took great care to integrate duly verified democratic countries in the usual inception of representative democracies. This indirect democracy was nevertheless attractive enough to be largely praised and therefore attractive for masses of people in countries which had endured dictatorships for long periods of time, such as Portugal, Spain or Greece. But beyond that, the very nature of the method of integration of the EU dates back to the early times when Germany and France were the two active pillars of the process. Two elements were then key in the process: first, everything has to be written down, no discretionary power given, no automatic adjustment assumed; everything should go by the rules, from civil servants to states representatives, including markets! Second, the general objective beyond this ruling should be to preserve and develop a social welfare materialised in different ways in member countries, especially in the various kinds of tripartite arrangements between workers, capitalists and governments that took forms in the aftermath of World War II and that are often referred to as 'full employment conventions'. The first element is often and rightly tied with the philosophical current of the ordo-liberalism that was developed in the interwar period by the Fribourg school of thought and with which Walter Eucken was associated. In those troubled years of the rise of Nazism, a large mistrust in a discretionary power left to the State to intervene in the economy was quite understandable. Its legitimacy was fully re-enforced in the aftermath of World War II, considering the atrocities of the war and the responsibilities of many governments. One should not forget that this insistence on going by the rules also implied the ruling of markets. One can easily see the success of this philosophy when considering the creation of international treaties with very different national societies where things had better be written down and why implicit assumptions relying on current practices (a kind of common law) can be misleading. The second element has somehow been largely obfuscated with time when it was clear and vivid at the very beginning of the EU integration process.

What was referred to under the qualification of full employment conventions were indeed a set of mainly written laws acting in the 'Philadelphia spirit' (Supiot 2010) which prevailed in 1944 and led to the declaration of basic principles of the International Labor Office (ILO)[6] and which was debated and turned into various laws in the western world, both to materialize the aspiration to a new era of justice after World War II and to respond to the political challenges of the socialist block.[7]

How the two elements, the ordo-liberalism and the full employment convention, exactly mix in the process of EU integration should be followed precisely over time. It is clear that every member state had its own balance of the two. But if one considers Germany where one tends now to see only the ordo-liberal component, it cannot be understood if one does not start from the large mix that the Rhenan capitalism constituted.[8] Conversely, France, with its long historical experience, had less defiance of the State (despite the Vichy episode) but still marked its attachment in the post war era to conventions, pacts and written laws. The weakness of this combination seems to have been that while the exercise of drafting rules may have been cumulative and shared among member states, as shown in every process of enlargement where newcomers had to take onto their legislation these 'acquis communautaires' and to comply with all the mechanisms that the EU kept developing, the full employment conventions remained very country specific. Even worse than that, they had been somehow under attack at the turn of the 1980s when the diffusion of the neo-liberal ideology started to stress as a universal medicine the flexibilisation of the labour markets. This was not so much supported initially by the EC but mainly by the OECD, the neo-liberal 'revolution' being much supported by the US president and UK prime minister of the time, namely Ronald Reagan and Margaret Thatcher, respectively, remembering that the UK entered the EU only in 1973.

[6] For the text of the ILO Philadelpia declaration of 1944 see http://www.ilo.org/wcmsp5/groups/public/---asia/---ro-bangkok/---ilo-islamabad/documents/policy/wcms_142941.pdf

[7] To illustrate this dual motivation, let us recall that the United States Congress passed a law in 1946 called the Full Employment Act and in France the program of the resistance inspired the labour laws setting the framework of social security in the aftermath of World War II.

[8] One can find a good reassessment of this duality or compromise between ordo-liberalism and social Rhenan capitalism in an article by François Denord, Rachel Knaebel and Pierre Rimbert in *Le Monde Diplomatique* August 2015. See also on Rhenan capitalism Albert 1991.

The motto of labour market flexibilisation has been pervasive through the years and the EU internal policy embarked on these lines especially after the 1990s when the financial liberalisation and the ensuing reallocation of production processes put a strong pressure on low paid workers in developed countries.

The German reunification also changed the balance in Germany where Rhenan capitalism lost part of its roots and attraction leading, in a few years, to a complete opposite movement with the Hartz reforms of the labour laws implemented in Germany between 2003 and 2005. It created an ancillary labour market dominated by low wages and not subject to social rights. No wonder that it was followed by a noticeable (above average) increase in income inequality, a trend that one finds in most developed economies during the same period of economic liberalisation. This derailment diffused more or less to all member states where dualism of labour markets seemed an answer to the challenge of external competition and delocalisation of work places. The rise of China and other emerging economies seemed to impose such drifts as norms of labour markets in open economies. A new German model emerged with countries such as France considering whether or not to make its own Hartz reform, forgetting that the competitiveness of German products in the Rhenan model was based on non price competitiveness; it was more based on the quality of the labour force and its implications in work processes than its low wages. Still, countries in the EU have mixed feelings about the change, and the assessment on the relative failure of the Lisbon agenda in the mid 2000s created the necessity to turn to a more inclusive growth project. The Agenda 2010 insisted on avoiding such drift. It also insisted on the importance of the benchmarking exercise among member states to determine the best practices.[9] Had it been done in the spirit of the early compromise between ordo-liberalism and the full employment convention drive, such an exercise could have helped to counter the drift to dualist labour markets.

The Agenda 2020 still stressed the objective of inclusiveness. The new commission has also retained an objective of support of minimum wages in member states as it was evoked in the EU election

[9] An Open Method of Cooperation, already mentioned in the 2000 version of the Lisbon strategy that had been little effective (see Chap. 3).

campaign of 2014 by candidate Juncker who was confronted with the poor figures on unemployment and wages in the union. Germany has introduced a minimum wage to be implemented by 2017. France is pushing for a minimum wage across the whole union. How effective this minimum wage, which would launch a common action against the dualism of European labour markets, will be remains an open issue. Clearly some other moves would be complementary; things such as some harmonisation of the fiscal systems of member states. Talani, in Chap. 2 of this book, stresses that such reshuffling may be starting, even if it is likely to be a long process. In the same Chap. 2 she also explained that it took some time for the ECB to be able to launch the equivalent of the quantitative easing that the US Federal reserve put in place to reflate its economy. The time length of the method is definitively a lasting characteristic of the EU method of integration. Any foresight of its evolution thus requires a long-term view of its main underlying factors. Considering this perspective, we looked at the evolution of what we called the two components of the methodology of the EU integration process. It may be the case that the decay of the 'full employment convention' component has reached a critical point where it has, one way or another, to be revivified or change for a new compromise to face the risk of a fatal hollowing out of the whole process of the union. The Greek crisis, exposed in Chap. 6 of this book, is very telling of this limit. On one side there is in Greece a comprador class of people wheeling and dealing in finance, trade and military businesses which escape any control and tax. On the other side, there are the representatives of the Eurozone trying to restore a financial discipline on the public debt in strangely formal ways unrelated to social realities (aiming at reducing wages, pensions and social costs which have already reached minimum levels) and without macroeconomic possibilities (the imposed stagnation will not allow any payback). Rigidity on imposing unrealistic rules by the EU authorities versus incapacity of the Greek state to control profiteers of different kinds both combine to produce the deadlock of the greek crisis. All of this outlines the astonishing lack of dynamics of a Union of 29 countries which cannot find a proper solution for one of its members repre-

senting less than 1.3 % of its overall GDP.[10] This impasse on the Greek issue is symptomatic of a much wider blockade of the EU dynamics. If the Greek case is a caricature, what happened in other southern countries such as Italy (see Chap. 7), Spain and Portugal[11] are also telling of the detrimental effects of a European Monetary Union that lacks the means to counter the diverging forces spurred in fully open economies by a lasting misalignment of real exchange rates. As stressed in Chap. 3 a closer integration of economic policies among member states has still a long way to go and has to be based on a tighter economic integration as well as an enhanced democratic accountability. Does that mean that this objective is plainly out of reach? This has to be questioned, trying to assess and calibrate potential policies and effects in both quantitative and qualitative terms.

9.3 Charting Ways Out of the European Union Impasse

Calibration and assessment of alternative policies have an important role to play in the debate showing that some steps that are not insuperable in both economic and political terms can really lead to situations where policies have more room for manoeuvre. A major factor of stagnation in the EU is currently the lack of investment. Forcing public investment to substitute would be a victory à la Pyrrhus if it did not meet some crucial requirements. The first question may be referring to the scale of the investment under review. For the time being, the budget of the EU amounts to some 1 % of the GDP of the union (e.g. some 145 billion euros) while the federal budget of the USA is almost 21 % of their GDP (e.g. some 3.8 trillion dollars). This huge difference is raising an issue of scale regarding an increased intervention in the EU budget. Clearly, to organize a transfer from national budgets to reach an EU 'federal' budget of such an order of magnitude cannot be imagined

[10] Or 1.8 % of the GDP of the countries of the Eurozone.

[11] And some would add France to this list viewing its poor performances in terms of employment and trade balance. See Chap. 3.

in the foreseeable future. Conversely, doubling the EU budget may not have any meaningful impact that would bring room for manoeuvre. In a foresight exercise of the AUGUR project (AUGUR being the name of an EU project of the 7th framework program)[12] we have calibrated the impact of a five times bigger EU budget. It led to significant variations of the main macroeconomic indicators of the EU. All variations contributed to improving the performances at medium term without putting the EU back on a growth trajectory that would have solved all debt and employment problems. In effect, much depends on the assumptions retained for the rest of the world. In a world still struggling on, mired in a lasting stagnation induced by the financial crisis, the effects are small but hinting at some room for manoeuvre for the European economies under review. Such calibration, though, is not the end of the story. The conducive conditions under which such dynamics could occur in a satisfactory way are many. In the first place, changes in GDP which are not qualified in terms of their effects on distribution and wellbeing may fall short of having the legitimacy and the impulsive effects expected. Debates on 'beyond GDP' have rightly stressed the limits of this gross indicator. It has to be completed by some specification of the impacts of the investments done. This would help to feature more precisely the development trajectories and allow chiefly to check to which major challenges they respond. In this perspective we shall, retain three major challenges as broad objectives to be met, in order for an investment scheme to benefit of a full legitimacy and embark in comprehensive cumulative dynamics.

The first challenge has to do with the reduction of the diverging forces, following the objective of the EU structural funds of the past but with a will to effectively check the redistributive nature of the investment scheme both among and within nations. An assessment in terms of wellbeing improvements would eventually increase the consistency with the objectives that follow. It also matters that these effects should be rather evenly distributed among those in need and should not occur in a too distant future in order to rally around the scheme many people who will look at

[12] See Eatwell et al. eds. (2014) and Cripps et al. (2014).

it as a new compromise, intending to reverse the continuing decay of the old 'employment convention'.

The second challenge has to do with the environmental threat, which is presently on the agenda of nations with the COP 21 conference of December 2015. The imperative of strong actions on the environmental front is comprehensively addressed in Chap. 3, listing some of the specific conditions that would ensure to launch some cumulative dynamics. The involvement of citizens in such an environmental battle is a key issue for the legitimacy and social acceptability of the scheme. They should really feel committed and judge the implementation of some measures as directly improving their welfare, hence a necessity to develop a wide variety of actions in order to impact living conditions (such as promoting the share economy, among others). Attention should also be paid to the various impacts on the economies of the firms. Not only incentives for more efficient uses of non-renewable resources should be developed but also the legal framework to ensure the preservation of the environment.

The third challenge to be met concerns the domestication of finance. The environmental policy is likely to be faced with multiple choices and end up in complex architectures to meet all the above conditions. This carries the risk of privileging market forces to sort out these choices, all of which would in turn be open to speculative financial moves. The domestication of finance is therefore a primary condition for the success of a sophisticated investment scheme. It implies some further reregulation of finance and all the more so that speculative financial runs have resumed in a world where quantitative easing has been largely practiced to boost economic activity, echoing a warning made by Robert Shiller at the launch of the third edition of his book on irrational exuberance.

The investment scheme thus required to lead to a socially acceptable and environmentally sustainable trajectory is ambitious. It implies that the EU comes to support a daring and comprehensive approach to the environmental issue where social cohesion among and within member states is effectively seen as a cornerstone of success. The road to success of such offensive integration policy remains strongly conditioned by what will occur in other parts of the world. Consistently, actions have to be

taken to help and associate others to share the objectives on the global environmental issue. There is little alternative.

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L.S. Talani (ed.), *Europe in Crisis*,
DOI 10.1057/978-1-137-57707-8

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