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Article

The Eurocrisis: Muddling through, or on the Way to a More Perfect Euro Union?

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This paper looks at the short history of the Eurozone through the lens of an evolutionary approach to forming new institutions. The euro has operated as a currency without a state under the dominance of Germany. This by itself may be good news, as long as Germany does not shirk its growing responsibility for the euro's future. This would require Germany to invest more in upgrading Eurozone institutions and balancing its dominance gains with the economic and political responsibilities that come with it. Germany's resilience and dominant size within the EU may explain its 'muddling-through' approach toward the Eurozone crisis: doing enough to prevent the unraveling of the Eurozone while resisting policies that may mitigate the depth of the crisis if they involve short-run costs to Germany. We review several manifestations of this muddling-through process. Germany's attitude toward the Eurozone resembles the attitude of the United States toward the Bretton Woods system in the 1960s – benign neglect of the growing tensions, which led to the ultimate demise of the Bretton Woods system. Chances are that unraveling the Eurozone would be much more costly than the end of the Bretton Woods regime. One hopes that the muddling-through process would work as stepping-stones toward a more perfect euro union, yet hope may not be enough to deliver it.
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The euro – a currency without a state

After more than seven years, the euro is firmly established as the currency of over 300 million people. Its internal stability is evidenced by the fact that inflation has been steadily low from the very start, despite a sequence of negative price shocks (in particular a continuous surge in oil prices). As an international currency, the euro is second only to the US dollar.

> The EU has always been, and will remain, a unique undertaking for which there are no models that can easily be adopted. It is important to allow an evolutionary process, which is open to further steps of integration, yet safeguards what is already in place and working well, and which assigns competencies to nation states or even regions as appropriate. In fact, we have been in the midst of such a process for quite some time, and Monetary Union is and will remain one of its major success stories.

The opening and the closing of a speech by Otmar Issing, Member of the Executive Board of the ECB, Helsinki, 24 March 2006

INTRODUCTION

The short history of the Eurozone has been remarkable and unprecedented: the euro project has moved from the planning board to a vibrant currency within less than 10 years. Earlier concerns about the stability of the transition from national currencies to the euro as well as skepticism regarding the gains from forming the euro were deemed overblown by the mid-2000s. Issing's optimistic 2006 speech reflects well the buoyant assessment of the first decade of the euro – an unprecedented formation of a new currency without a state. Observers viewed the rapid acceptance of the euro as a viable currency and the deeper financial integration of the Eurozone and the EU countries as stepping-stones toward a stable and prosperous Europe. The growing current account deficits of GIIPS (Greece, Ireland, Italy, Portugal, and Spain) were caused by borrowing at low sovereign spreads. Intriguingly, GIIPS bonds' interest rates dramatically converged during the 1990s to the German rate (see Figures 1 and 2). The International Monetary Fund's (IMF) World Economic Outlook (IMF, 2008) viewed emerging Europe's large current account deficits as a validation of the gains associated with 'capital flowing downhill',[1] possibly dispelling concerns about the limited benefits of importing foreign savings as a means of financing domestic growth.[2] The celebratory assessment of the euro continued well into

[1] IMF (2008, October, p. 228) noted '… emerging Europe's ability to borrow foreign capital for long periods suggests that the standard growth model, with capital flowing downhill, remains relevant.' 'In emerging Europe, the large current account deficits are related to a rapid liberalization of domestic financial markets and open capital accounts, which attracted large capital inflows and prompted a rapid rise of foreign bank ownership. The process of integration into the EU also enhanced foreign capital inflows by improving prospects for economic and policy stability'.

[2] Gourinchas and Jeanne (2006) found that the welfare gains in switching from financial autarky to full capital mobility equal a paltry 1% increase in domestic consumption for the typical emerging market. Aizenman *et al.* (2007) and Prasad *et al.* (2007) noted that fast-growing developing countries have tended to self-finance their investment, and run current account surpluses.

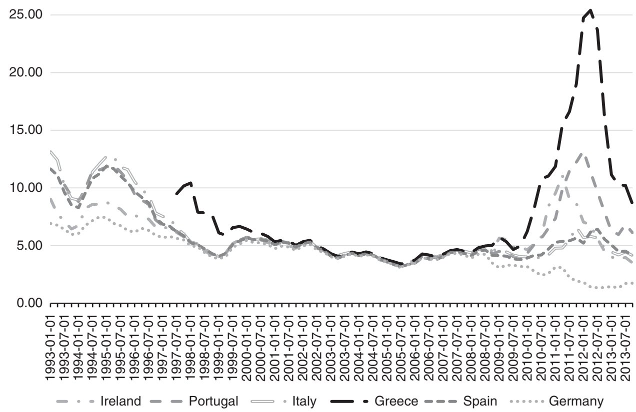

Figure 1: GIIPS and German Government Bond Rates
Source: ECB, Bloomberg, http://iuwest.wordpress.com/

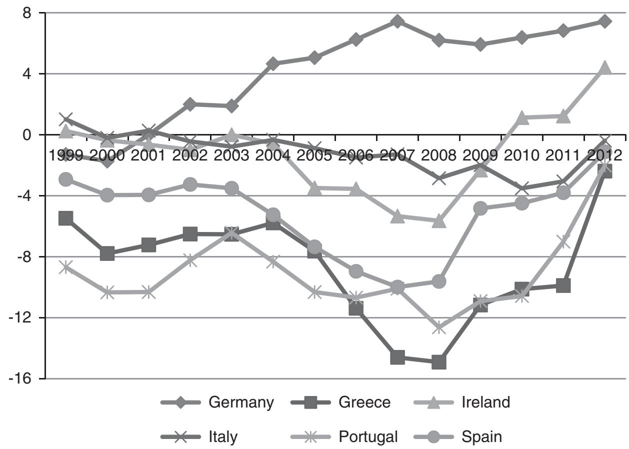

Figure 2: Germany and GIIPS current account, % of GDP, 1999–2012
Source: IMF WEO, April 2014

its tenth-year anniversary (Weber, 2008; Jonung and Drea, 2010), only to crash by the unfolding events of the Eurozone crisis.

This paper looks at the short history of the Eurozone through the lens of an evolutionary approach to forming new institutions. This lens provides a useful perspective on the formation of global exchange-rate regimes, currency unions, and the like. The essence of the evolutionary approach is that the formation of institutions like unions and currency areas is not unidirectional process.[3] Evolutionary pressure purges arrangements and institutions that do not survive the realized shocks. Yet, survival does not necessarily imply the ability to withstand future turbulences. Thus, convergence to 'ever closer union' is not assured.

THE FORMATION OF NEW INSTITUTIONS AND THE EVOLUTION OF UNIONS

The formation of the euro is an example of an excessively optimistic attitude to policies and to the creation of new institutions – an upbeat optimism that may help overcome the opposition to policy changes. The hope is that the formation of a currency union (like the euro) may lead to dynamic forces inducing an 'ever closer union' (Hass, 1958), as the processes of market integration and cooperation do mutually reinforce each other. This approach reflects also an optimistic assessment of the 'bicycle theory' of unions (Moravcsik, 2005). Like a biker who has to keep going to avoid falling over, European integration has to progress in order to avoid its collapse. Accordingly, the establishment of Economic and Monetary Union will, over time, trigger further integrative steps. This view is a variant of the 'Endogenous Optimal Currency Area Theory' (Frankel and Rose, 1997), predicting that the participation in a common currency area reduces overtime the asymmetry of shocks, thereby countries are more likely to satisfy the criteria for entry into a currency union after taking steps toward economic integration than before.

Frequently, a rosy and upbeat attitude to policies may reflect built-in fiscal myopia, possibly at the level of both the principal (the policymaker) and the agents (consumers and households). Households' myopia may indicate hyperbolic discounting, where the present-biased consumer excessively discounts future consumption relative to the conventional expected utility (Leibson, 1997). Belt tightening is delayed for tomorrow, but 'tomorrow never comes'. Policy-makers' fiscal myopia may reflect the 'short-termism' associated with a limited time in office, and the possible short-sightedness of hyperbolic discounting voters.[4]

[3] Applying evolutionary logic in economics goes back to Veblen (1899) and the Austrian evolutionary school, with further developments applying Evolutionary Game Theory (Hodgson, 1998; Young, 2001 for overview and references).

[4] Even forward-looking policymakers may opt to sequence the formation of new institutions taking into account the limited capacity and support in dealing with contingencies that are viewed by the public as low probability events. In these circumstances, policymakers may prioritize the formation of policy instruments and new institutions dealing with tail risks, along the line of 'don't wake up sleeping dogs'. This attitude was probably reflected in European Commission President Romano Prodi's statement in 1999, 'I am sure the euro will oblige us to introduce a new set of economic policy instruments. It is politically impossible to propose that now. But some day there will be a crisis and new instruments will be created'.

Both patterns are associated with probable time inconsistency. In these circumstances, proper institutions may help. Yet, effective institutions cannot be imposed from the outside. Forming the institutions dealing with fiscal myopia frequently requires painful learning from crises, which in turn may galvanize the will to reform. A clear example of such a process has been the evolution of fiscal rules in Chile in recent decades, highlighted in Frankel (2011).[5]

The evolutionary perspective suggests that 'Optimal Currency Area' literature has been too simplistic, ignoring the willingness of vested local interests to oppose deeper unions. Unions and regional cooperation arrangements are challenged by exogenous forces, testing the willingness and ability to persevere during bad times. Market integration and cooperation may overshoot the willingness to integrate. The collapse of Yugoslavia, and the move toward more limited fiscal federalism in Canada provide vivid examples of these patterns. Frequently, the reasons for the formation of currency unions and regional cooperation blend economics and politics. The euro has been the outcome of Europe's nineteenth and twentieth century history, rather than the 'Optimal Currency Areas' logic (Bordo and Jonug, 1999; Bordo *et al.*, 2011, for detailed overviews of the history of unions).

Putting the euro crisis in the proper historical context, the US dollar is a 'successful' union of 50 states. Yet, this is the outcome of painful learning and a turbulent history of more than 200 years. Key chapters in this history include defaults of eight US states on sovereign debt in the early 1840s; the Civil War; the emergence of the Federal Reserve System as a key institution; the Great Depression and the emergence of the deposit insurance supervised by the FDIC; and the greater fiscal role of the federal system in post-World War II (see Aizenman, 2012 for further discussion about the formation of these institutions in the United States). The euro area is a 'baby union', facing its first painful maturing crisis. The spectrum of options facing the euro project includes progressing toward a Canadian or US type of a union, with a more significant role of the fiscal center than the one framed by the euro founding fathers, or contrary, scaling down the euro project. Euro area countries attempted to ignore the learning process of the United States and other unions, at their own peril. The crisis forces the emerging euro to move faster on the learning curve. The process is quite painful, as has been the learning process for the United States.

The short history of the euro provides already a vivid example of its evolution. TARGET2 balances were established 'as the real-time gross

[5] Frankel (2011) showed that official forecasts of budgets and GDP in a 33-country sample are overly optimistic on average. The bias is stronger for longer horizons and in booms. Chile learned from past volatility and crises, experimenting during the 2000s with innovative fiscal rules supported by entrusting the needed forecasts to independent expert panels.

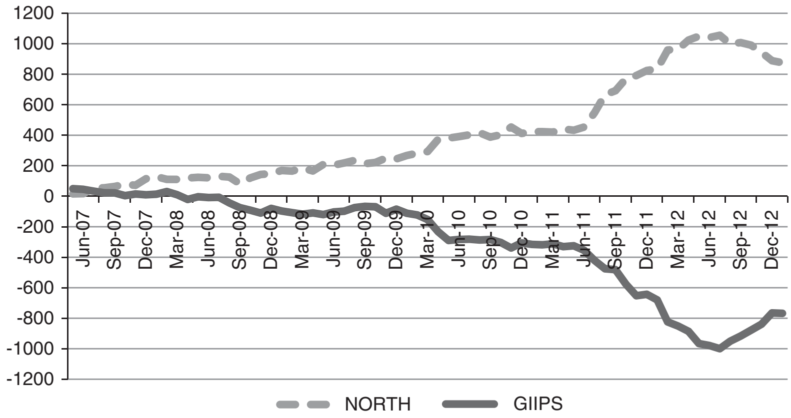

Figure 3: Net TARGET2 balance, bn €. Northern Eurozone, (Germany, Netherlands, Luxemburg, and Finland) and of the GIIPS
Source: Euro Crisis Monitor, Institute of Empirical Economic Research, Osnabrück University

settlement system owned and operated by the Eurosystem', where 'payment transactions in TARGET2 are settled one by one on a continuous basis, in central bank money with immediate finality'.[6] As such, TARGET2 is a settlement system intended to economize on clearing large volumes of gross payments between the regional central banks in the Eurozone. A settlement system may work well in times when the gross flows are adding up to small net changes in the credit/debit position, as was the case until 2008. In mid-2007 the balances in TARGET2 were negligible: in June 2007, Germany had a credit of €18 billion in the TARGET2 system, and the GIIPS had a combined credit of 50 billion. Five years later, Germany's credit mushroomed to €729 billion, whereas GIIPS credit flipped to a debit of €966 billion (Figure 3).[7] This led Sinn (2011), Tornell and Westermann (2012), and others to raise concern that the tight correlation between the increase in German credit and the GIIPS debits in TARGET2 is a manifestation of a common pool problem, leading to a modern version of the tragedy of the commons. Accordingly, the GIIPS' co-financed their current accounts deficits via their central banks' accelerated borrowing from the Bundesbank, intermediated by the TARGET2 system. This is a major concern in the context of the Eurozone, as the lack of formally established backstop mechanisms may result in a piecemeal *ad hoc* approach toward the stabilization of the Eurozone countries' banking system. Such an approach

[6] Taken from the ECB web page, http://www.ecb.europa.eu/paym/t2/html/index.en.html, accessed 26 July 2014.
[7] Data taken from Euro Crisis Monitor, http://www.eurocrisismonitor.com/.

may induce a growing *ex-post* risk sharing in the Eurozone, without building the institutional structure to mitigate the future moral hazard consequences.

Indeed, the accelerating run on the GIIPS banking system induced the formation of a complex web of liquidity infusions by the Eurozone's institutions: the creation of the EFSF (*The European Financial Stability Facility*) in 2010, established as a temporary rescue mechanism to provide credit assistance; the use of LTROs (*Three-year Long Term Refinancing Operations*) in 2011–2012; on 22 December 2011, the European Central Bank (ECB) started its *LTROs*. It loaned €489 billion to 523 banks for a period of 3 years at a rate of 1%. On 29 February 2012, the ECB held a second auction, LTRO2, providing 800 Eurozone banks with further €529.5 billion in cheap loans. The ELS (*Emergency Liquidity Assistance program*) unveiled in 2013, and the accelerating increase in TARGET2 balances in 2011–2012 (see Figure 3 and the discussion in Tornell and Westermann, 2012).

The wish to stipulate more formal and enduring backstop mechanisms provided the impetus for the evolution of a new institution, morphing the EFSF into a permanent rescue mechanism in 2012, the European Stability Mechanism (ESM). The ESM provides financial assistance to euro area member states experiencing or threatened by financing difficulties, replacing the EFSF once all loans outstanding under EFSF assistance programs have been reimbursed, and all funding instruments issued by the EFSF have been repaid in full. To fulfill its purpose, the ESM raises funds by issuing money market instruments as well as medium- and long-term debt with maturities of up to 30 years. ESM issuance is backed by a paid-in capital of €80 billion. Its goal is to provide an instant access to financial assistance programs for member states of the Eurozone in financial difficulty, with a maximum lending capacity of €500 billion. The ESM cooperates very closely with the IMF – a euro area member state requesting financial assistance from the ESM is expected to address, wherever possible, a similar request to the IMF. While one doubts the capacity of the ESM to solve the ultimate needs of a credible backstop mechanism for the euro, it is another step in the evolution of the Eurozone in search for a more perfect union.

THE EUROZONE: PRESENT AND FUTURE CHALLENGES, AND THE ROLE OF GERMANY

Looking at the short history of the Eurozone, Issing's optimism on 'The euro as a currency without a state', overstates the evidence. At best, the euro is *a currency without a state, under the dominance of Germany*. This statement by itself may be good news: Cohen (1994) identified two crucial political characteristics common to sustainable currency unions: first, the presence of a dominant state 'willing and able to use its influence to keep a currency union functioning effectively', and second, the presence 'of a broader constellation of related ties and commitments sufficient to make the loss of monetary autonomy, whatever the magnitude of prospective adjustment costs, seem basically acceptable to each partner'. The growing dominance of Germany in the Eurozone suggests that it may meet Cohen's first characteristic. Yet, Germany would stabilize the Eurozone as long as it does not shirk its growing responsibility for the euro's future. This would require Germany to invest more in upgrading Eurozone institutions and balancing its dominance gains with the economic and political responsibilities that come with it. A lingering challenge of the euro remains meeting Cohen's second characteristic, a work in progress that may require depending labor mobility, and the convergence to banking union.

Ironically, there are curious parallels between the global role of the United States since the end of the Bretton Woods system and the role of Germany in the Eurozone. The presumption in the 1970s was that the demise of the Bretton Woods system would propagate a symmetric global financial architecture, where major currencies would freely float against each other. Within two decades, it became clear that in the post-Bretton Woods system, the United States had kept its hegemony. The US dollar has retained its position as the leading global currency, with the country enjoying the exorbitant privilege of running current and growing account deficits supported by an increasingly vibrant demand for US government bonds by the foreign central banks, as well as by the private sector in foreign countries (as 'safe haven asset'). The global financial crisis, propagated globally from the United States, induced a reluctant US Treasury and Federal Reserve Board (FED) to adopt unprecedented steps aiming at stabilizing the global economy.

In the same vein, the presumption was that forming the euro as 'a currency without a state' would provide a more symmetric structure to Europe and contain the fear of a German hegemony. This supposition seemed to work in 'good times' – the first decade of the euro. The Eurozone crisis put an end to the euro honeymoon, bringing to the fore the key importance of Germany's economic and political decisions in determining the Eurozone's viability and future. The challenges associated with managing the growing fragility of the euro may induce a reluctant Germany to face an upcoming stark tradeoff: the vibrant growth of Germany, while running large current account surpluses under a pegged exchange rate with the other Eurozone countries, may come to an abrupt end if the Eurozone unravels.

Germany has not yet been exposed to the full costs of the macro straightjacket associated with the euro. The economic benefits of the Eurozone to Germany and GIIPS were initially frontloaded. Arguably, the improving growth and current account surpluses of Germany during the first decade of the euro were the outcome of earlier investing in structural reforms as well as the euro's growing credibility at the time. Being a member of the Eurozone mitigated Germany's real appreciation, in comparison with retaining the Deutsche Mark. For GIIPS, the availability of cheap borrowing at a time of growing optimism about the euro supported growing current account deficits; vibrant consumption and investment, which eventually contributed to unsustainable growth and real estate booms.

Similar to the experience of emerging markets that liberalized financial systems in the 1990s under a fixed exchange rate, the increasing costs of the resultant balance-sheet exposures were below the radar screens of markets and policymakers, until an abrupt stop, which was followed by capital flight crises (Calvo, 1998). This may reflect a fundamental problem with the pricing of sovereign risk in which the private sector, as the 'interest rate taker', overlooks the growing marginal impact of borrowing on sovereign risk (Aizenman, 2004). This externality also holds under a flexible exchange rate, but has probably been magnified by the economic strength of the Eurozone core and by moral hazard – the presumption that the growing costs of unwinding the euro will induce bailouts down the road. Chances are that the elusive 'Great Moderation' did not help by masking the growing tail risks in the OECD countries (Rajan, 2005). The countries joining the Eurozone experienced two decades of growing optimism associated with their deepening financial integration and convergence to low inflation before the Eurozone version of the 'capital flight' crisis hit.

The Eurozone crisis forced GIIPS to confront the costs of their excessive borrowing before the crisis, as the crisis terminated the countries' easy access to funding their current accounts and addressing their growing fiscal deficits. In contrast, beyond the growing balance-sheet exposure of its financial system, Germany has not yet been fully exposed to the downside risk of higher unemployment and lower growth that has already hit most of the Eurozone countries (see Figure 4). The resilience of the German economy probably reflects the advantage of running a sizable current account surplus under a fixed exchange rate with its Eurozone counterparts; the relative efficiency of the German labor market; and the country's specialization in exporting advanced manufacturing products and highly demanded capital goods. Germany's resilience and dominant size within the EU may explain its 'muddling-through' approach toward the Eurozone crisis. The muddling-through approach is akin to walking on a double-edged sword: *doing enough to prevent the unraveling of the Eurozone while resisting policies that may mitigate the depth of the crisis if they involve short-run costs to Germany.*

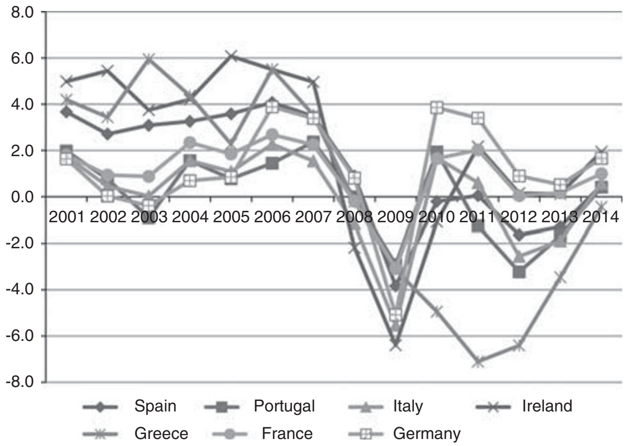

Figure 4: Real GDP, percentage change from previous year, 2001–2014
Germany, France, and the GIIPS
Source: OECD

A manifestation of this approach is the revealed asymmetric bias of the ECB inflation targeting. The short history of the ECB reveals a strong deflationary bias, which probably reflects the well-known German aversion to moderate inflation. A hint of this bias is provided in Issing's (2006) opening statement: 'Its internal stability is evidenced by the fact that inflation has been steadily low from the very start, despite a sequence of negative price shocks (in particular a continuous surge in oil prices)'. A symmetric inflation targeting would also require an aggressive expansionary monetary policy in the presence of a sequence of deflationary prices shocks, such as a sequence of lower prices of commodities, and other deflationary developments that impact the Eurozone's consumer price index.

So far we have not seen the willingness of the ECB to follow symmetric inflation targeting. Observers have noted that the ECB's revealed inflation targeting is closer to targeting Germany's inflation rather than targeting inflation of the entire Eurozone. While this may not be a surprise considering the bargaining clout of Germany, the resultant low Eurozone inflation – estimated at 0.3 in September 2014 – puts further drag on the adjustment of GIIPS. The net outcome is the continuation of accelerated debt deflation, which pushes the Eurozone toward the Japanese style of lost decades (see iMFdirect, 2014). The news in September 2014 suggests that Germany enters a recession, possibly impacting down the road ECB's stance. Bloomberg News reported on 1 September 2014: 'Cracks are emerging in Germany's once rock-solid economy as companies' reluctance to invest bears out Mario Draghi's warning that the euro-area recovery is in danger. Gross domestic product in Europe's largest economy shrank 0.2% in the second quarter, the Federal Statistics Office said today, confirming an Aug. 14 estimate. While part of the drop can be attributed to a mild winter that front-loaded output earlier in the year, the Bundesbank has cast doubt on a second-half rebound and suggested its forecasts may prove too optimistic. The weakness of a German economy that has outperformed its peers since the regional debt crisis comes as European Central Bank President Draghi ponders adding more stimulus to fight the threat of deflation in the currency bloc. He signaled that declining inflation (ECCPEST) expectations could tip the ECB into broad-based asset purchases'.

The risk of lost decades for the Eurozone is much greater than the risks that faced Japan: low employment and growth in the Eurozone would increase the strength of the 'anti-euro' camp, leading to deeper social and political instability and threatening the survival of the Eurozone. There are several key differences making lost decades much more destabilizing in the Eurozone than in Japan. Unlike the Eurozone, Japan is a mature currency and fiscal union of its 47 prefectures, a country with large net foreign asset position, and overall homogenous population and economic structure.

Another manifestation of Germany's muddling-through approach is the prevalent view that its persistent current account surplus is a reflection of the country's efficiency and is irrelevant to the adjustment challenges facing the global economy, the Eurozone, and GIIPS. The debate about the merits of current account imbalance is as old as the debate about the merits of financial integration. On balance, this debate is less relevant at times of strong global growth, but at times of global deflationary stance; the global adding up property, stating that sum of global current accounts is zero, matters. It implies that current accounts of large countries matters in the global distribution of employment and economic activities. The sheer size of Germany suggests that its current account surpluses have a non-trivial effect on the Eurozone and the global economy (see Fratzscher's, 2013, 18 November *Financial Times* column). At times of global deflationary pressure, global employment is not a zero sum game – higher investment and lower saving in surplus countries would help in mitigating global protectionist threats and underemployment pressures.

Ironically, Germany's attitude toward the Eurozone resembles the attitude of the United States toward the Bretton Woods system in the 1960s – benign neglect of the growing tensions, which led to the ultimate demise of the Bretton Woods system: '… the new (Nixon's) government took no initiative to do anything about the monetary turmoil as long as it did not see its domestic priorities endangered by the "market". First, it tried to get domestic inflation under control by tightening macroeconomic policies and cutting government expenditure. When this policy failed and appeared to scare away voters, the government undertook a series of expansionary steps which struck the fatal blow to the Bretton Woods system. … As a result of the policy of 'benign neglect', however, the US deficits rose out of all proportion. When the dollar-holders desperately tried to cash in their reserves, Nixon acted in August 1971, after years of precipitously increasing speculative crises, closed the gold window, imposing a ten percent surtax on all imports' (Zimmermann, 2002, p. 66). Chances are that unraveling the Eurozone would be much more costly than the end of the Bretton Woods regime (see Eichengreen, 2013).[8]

Looking forward, the evolution of other unions suggests that monetary unions morph overtime into a financial union. This was vividly illustrated in the United States by the formation of the FED in 1913 in response to a series of financial crises, particularly the severe panic in 1907. The Great Depression and the lackluster performance of the FED during the 1930s nudged the United States into a deeper financial integration, including the formation of the FDIC, serving both as deposit insurer of last resort, as well as the resolution agency involved in banking bankruptcies. As each state in a union gives up its capacity to use monetary policy to back up its banking system at times of peril, it forces the union's central bank to embark at times of peril on 'extraordinary credit policies' akin to the one undertaken by the ECB and the newly formed institutions (see the review in Section 2). The inability of each state in isolation to prevent a run on its banking system, illustrated by the financial panics impacting the GIIPS, put to the fore the need for a more integrated and unified financial system. Furthermore, the common pool problem associated with using central bank's credit facilities needs also a centralized supervisory system.

The growing clout of Germany in the Eurozone, magnified by the lackluster performance of Francs, put Germany in the role of agenda setter, having the capacity to facilitate the convergence toward a deeper financial union.[9] This potential role of Germany is well-captured in the 12 September

[8] The process of redenominating domestic euro deposits into domestic currency, which would then lose value against the euro, would trigger a system-wide bank run, at times that the ECB would be reluctant to provide the lender-of-last-resort support. As most euro governments are already in a weak fiscal position, they would not be able to borrow in order to bail out the banks and buy back their debt. This would induce a financial meltdown similar or deeper than that of the Argentinian crisis in the early 2000s, destroying the savings of the middle class. Chances are that such a process would trigger economic and political dynamics that may unravel the EU.

[9] Nominally, France is well-represented in the decision making, as is reflected in nominating Mr Moscovici, the former French finance minister, as the EU economy commissioner. However, the momentum in the EU shifted toward Germany's positions – the *Financial Times* commented on September 2014 'It was widely expected that Mr Moscovici's powers would be curbed when Jean-Claude Juncker, the new commission president, unveiled a new structure this month where a handful of vice-president commissioners would have oversight of their colleagues'.

2014 comments of Dr Elke König, President of the German Federal Financial Supervisory Authority, BaFin.

> In May 2014 the European Union finally adopted the Bank Recovery and Resolution Directive (BRRD). It tallies in many respects with the German rules and brings additional advances, especially in the clear regulation of creditor participation and cross-border issues. Member States have until the end of the year to transpose the Directive into national law. In Germany this is being done through the BRRD Implementation Act, which is currently going through the consultation phase, and in particular through the Recovery and Resolution Act. The resolution authority is to be the FMSA, or Financial Market Stabilisation Agency, which in a second step is to be incorporated into BaFin as an agency within an agency. The FMSA and BaFin are even now working closely together in order to structure the numerous interfaces between banking supervision and the resolution unit in the best possible way and also to ensure a smooth transition into the European resolution regime. In Europe we are at present also building the second pillar of the Banking Union, the Single Resolution Mechanism. In addition to a central banking supervision authority, the Single Supervisory Mechanism (SSM), which will be housed in the European Central Bank, from 2016 there will also be a central resolution authority, the Single Resolution Board, thereby creating the main regulatory framework at the European level. Nevertheless, this is a project that is still a long way from completion.

Answering the question: ‘Will Germany be able to assert its own interests properly?’ Dr König commented:

> BaFin represents the German position in numerous working groups in both the FSB and the EBA. Thanks to our many years’ collaboration we enjoy the trust of our partners there. In the FSB we chair the all-important committee on resolution issues. So we can play a crucial part in shaping the regulations. We are a member of a group of countries that set the tempo – be it in the international initiative to suspend call rights in the Master Agreements of the International Swaps and Derivatives Association or in the regulations governing gone concern loss-absorbing capacity, to mention but two very topical subjects.

These comments are in line with the evolutionary approach to the formation of unions outlined in previous sections. The blueprint outlined by the founding fathers of the Eurozone worked well through the convergence process to the euro, but failed in delivering a stable union. The euro crisis put to the fore the need to embark on a deeper financial integration, or to face the growing hazards of the Eurozone’s disintegration. The crisis also revealed the key role of Germany – being the largest creditor exposed to the hazards of GIIPS and the Eurozone's disintegration, Germany embarked quite reluctantly on the ongoing reform process of the euro. The gradual change in Germany's role probably reflects the growing recognition of the large costs of disentailing the euro, and the concerns about the growing political and economic uncertainty associated with prolonged Eurozone crisis.

While only time will tell if the Single Supervisory Mechanism and the Single Resolution Mechanism will mature into a stable and functioning framework, all the key parties are aware by now that the structural *status quo* of the euro is unsustainable, needing more experimentation with new regulations aiming at greater financial integration and centralized supervision. The experience of other unions suggests that this process is far from being harmonious, it takes time, and frequently is in reaction to crises that induced policymakers to focus on the need to reform, occasionally leading to new coalitions and to the formation of new institutions. Chances are that market pressures will induce the Eurozone to move faster than the United States in building more robust institutions – it took the crises of the early 1900s to form the FED, and for the Great Depression to induce the formation the FDIC and other related institutions. Indeed, the full interview with Dr König reveals that she is cognizant of these forces, and of the need to move faster toward deeper financial integration.

CONCLUDING REMARKS

In the first quarters of 2014, one detected green shoots that, with proper stewardship, could lead to the emergence of a more resilient and successful union. Output projections suggested that the worst may be over for GIIPS and recovery may be 'around the corner'. Their primary fiscal deficits have been drastically trimmed and are moving toward surpluses. GIIPS are also gaining access to borrowing at declining sovereign spreads. These developments may be the bonus of the 'positive contagion' triggered by Draghi's policy stance. The challenges facing the ECB and Germany is to do what it takes to prevent a reversal of these gains. The tentative recovery of GIIPS may be threatened if and when global interest rates rise, or when the risk tolerance toward GIIPS debt deteriorates. The chance of pushing these countries' further on the wrong side of the debt Laffer curve would be mitigated by a greater willingness for debt concessions tied to deeper structural reforms. The mixed messages from Germany regarding its lackluster support of Draghi's policies, including the country's constitutional court 'thunderbolt' ruling in February 2014, is the 'elephant in the room', raising serious questions about the durability of any green shoots.

In the same vein, the Balkanization of the banking system induced by the Eurozone crisis is also a double-edged sword. Rapid financial integration in the Eurozone before setting efficient and prudent supervision helped contribute to over-borrowing by GIIPS. The challenge facing the Eurozone financial system remains that of finding a healthy balance between banking integration and prudent regulations. This challenge remains a work in progress in both the United States and the Eurozone, and the hope is that GIIPS greater access to renewed borrowing will not backfire down the road.[10] An underappreciated development has been the growing mobility of labor in the Eurozone and in the rest of the EU. Bräuninger (2014) reports 'A rough Solow decomposition indicates that about one-tenth of Germany's economic growth in the past few years can be attributed to an increase in employment of citizens from Greece, Ireland, Portugal, Spain, and Eastern European partner countries'. (see Jauer *et al.*, 2014 for further analysis). Although this mobility is mostly confined to younger workers and immigrants, it facilitates easier adjustment and increases the flexibility of labor markets. Greater mobility of labor and lower mobility of under-regulated capital may be the costly 'second best' adjustment until the arrival of more mature institutions in the Eurozone.

Looking forward, one hopes that the Eurozone will use the muddling-through process as a stepping-stone toward a more perfect euro union. The challenges facing the Eurozone are not unforeseen or unprecedented. The history of other unions provides examples where crises, with the proper leadership, created new institutions and upgraded existing ones in ways that increased their resilience.

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[10] The banking system of the US was 'Balkanized' during the three decades post WW II. While this system came with its costs, the United States grew at a healthy rate during that period. The deregulation of the US banking system in the 1990s came with its short term benefits, and the longer run costs. Chances are that the growth challenges of countries are less the balkanization of their banking and financial systems, and more their structural distortions.

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