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The system paradigm and the European monetary union

What Janos Kornai's contribution to comparative economics can suggest to the Eurozone

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Abstract

The vision of Eurozone integration foresees that, under the pressure of the common currency, consistent policy action at Eurozone level and the active effort of member countries to actively comply with Eurozone institutions, national economies and systems would converge. This paper looks at Kornai's contribution to systemic analysis and reads the fundamental documents of Eurozone integration through Kornai's concepts and approach, while considering also other contributions. It is concluded that both the system paradigm and the system of the Eurozone are still undeveloped and this causes problems in the integration and its management. In particular, what is good for the progress of integration among widely sovereign countries leads to negative effects for individual countries, in particular to diverging performance between vulnerable and resilient countries. The paper concludes by considering proposals and changes that European and national authorities are submitting in order to fix the problems and strengthen the Eurozone problems.

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Content

Any complex social construction requires a paradigm, a framework which includes the basic assumptions, concepts, ways of thinking, and methodology that are commonly accepted and shared. While the term paradigm is usually referred to a scientific community, the use of this term here is justified by the ideal and scientific origin of the European integration and the many analysis and reports which led to the construction of the European Union and the Eurozone, all of which highlight the existence of a sufficiently coherent and shared vision of the process and its expected outcome.

A social construction also needs a system. In general terms, a system can be defined as "a regularly interacting or interdependent group of items forming a unified whole" (https://www.merriam-webster.com/dictionary/system retrieved on 9 January 2018) and can be described by its structure, purpose and working. A system can be defined in a simplified way through a model or can be referred to something existing, such as a society or a subset of it, such as an economy. The system's definition highlights that, whatever it treatment, a system is placed in and influenced by an environment and consequently defined in the frame of its boundaries – spatial, temporal, technical, political. The system we are dealing with there can be defined as the regularly interdependent and interacting set of components (institutions and organizations, such as countries, common and national organs) forming a unified whole: the Eurozone.

The official vision of the European monetary union foresees that, under the coordination of common institutions, the pressure of consistent European action and procedures, and the active effort of member countries, national economic systems would have converged to the Eurozone paradigm, if necessary with the help of selected structural reforms. While the goal of political unification remained somehow alive, it was not considered as essential to have a European economy working smoothly and strongly, even in the case of the Eurozone.

The European Union includes countries with different economic systems, countries which are only in part sovereign. This problem appears most clearly in the Eurozone. In fact, member countries transferred important parts of their sovereignty to the European Union, in particular to the common monetary authorities. At the same time, the EU and also the Eurozone remain incomplete as systems, because they include countries which kept their sovereign idiosyncratic institutions in many fields. This opens the question of the relation between national and EU institutions, the actual possibility that such a dual-level systemic arrangement actually works, and the consequences for member countries. In particular, and given national idiosyncrasies, difficulties and problems are likely to differ among member countries.

In the next section the paper looks at the fundamental documents of the European integration as the funding elements that can outline a Eurozone paradigm. Section 2 is devoted to Kornai's contribution to systemic analysis and looks at the Eurozone through his concepts and approach. The conclusion is that the Eurozone paradigm is unbalanced and incomplete and the Eurozone system is incomplete and needs a national level. While Kornai's concepts and method contribute importantly to the comprehension of the true nature and deep problems of the European integration, the latter gains if also other contributions are considered, in particular the New Comparative Economics and the Varieties of Capitalism approaches. This is the topic of section 3. Section 4 considers the consequences of the particular features of the Eurozone paradigm and system. On this basis, section 5 shows the rationality of policies that are used in the Eurozone, but also stresses how they are inappropriate to the broader goals of integration of member countries. This reasoning is considered further in section 6, which shows how the Eurozone construction leads unwillingly to implicit discrimination to the disadvantage of vulnerable countries. Policies and reforms implemented on this basis cause the performance of different groups of countries in the Eurozone to diverge, as section 7 stresses. However, section 8 considers that various attempts are being made in the Eurozone to overcome these problems, which give rise to some optimism. Section 9 concludes.

1. Monetary integration and the Eurozone paradigm

The European paradigm evolved through time (Dallago 2016). Monetary integration and the formation of the Eurozone through the Economic and Monetary Union (EMU) are the clearest and most demanding core of the paradigm. The requirements and the consequences of a common currency were the concern of the European Community as early as the late 1960s. An important step in this perspective is the "Report to the Council and the Commission on the realisation by stages of Economic and Monetary Union in the Community", better known as the Werner Report (1970). This report outlines a first, comprehensive vision of the future monetary union and is therefore the first definition of the Eurozone paradigm, a more complete and encompassing vision than was actually implemented so far and later foreseen by the Delors Report (1989). The latter, or "Report on Economic and Monetary Union in the European Community", takes from the former features and stages of the process to monetary integration, but is more pragmatic and important for successful achievements.

While the Werner Report aims at finding economic and financial conditions for promoting European integration, the Delors Report (and actual European management) is more interested in assuring financial stability, without paying the necessary operational attention to economic and social conditions and consequences. In the vision of the Werner Report what really matters in the monetary unification is the overall process of economic, financial and institutional convergence of the entire Community (now Union). This means that only the external equilibrium of the entire Community is important ("For such a union only the global balance of payments of the Community vis-a-vis the outside world is of any importance", p. 10). At the same time, internal equilibrium is considered as the outcome of the "mobility of the factors of production and financial transfers by the public and private sectors." That is, is realized "in the same way as within a nation's frontiers".

With ex post hindsight, this is a strong statement, but the Report is fully aware of the implications.[1] It does not relay naively only on market instruments, but considers the necessity of both convergence of and interdependence among member countries in any

[1] "Having regard to the marked differences existing between the member countries in the realization of the objectives of growth and stability, there is a grave danger of disequilibria arising if economic policy cannot be harmonized effectively." (Werner Report, 1970, p. 8)

economic domain, and the development of the powers of the common organs.[2] Along with policies, convergence must also concern institutions at both national and Community level.[3]

Thus the necessity to have a complete governance of European integration and the severe problems that would descend from the inability to implement the integration agenda were clear as early as 1970. The Werner Report can thus be considered as the main reference of the ideal European paradigm and as the basis for its future system. Why did the actual integration – and successive documents and treaties for that matter – pursue a different way, that led to an incomplete paradigm?

The Delors Report (1989) envisages a greater role for national governments and places confidence in the inter-country mobility of resources, but also the necessity to bind the financial freedom of member countries to keep stability of the monetary union.[4] Unfortunately, the Report's trust in self-adjusting mechanisms - geographical and sectorial mobility of resources, price flexibility, and lack of structural impediments – is not sufficiently met by European reality (see below). Here lies much of the problem of the Eurozone: insufficient resource mobility and structural problems that prevent resource mobility, together with unbalanced public finances in some countries and their national management and accountability in all member countries. To be sure, the Report is aware of the existence of impediments and their asymmetric consequences on the internal cohesion of the EU, but it apparently supposes that they can be effectively removed.[5] This opens the crucial issue of reforms.

The Delors Report represents the high moment of a pragmatic adjustment of aspiration to European integration from the shared vision based on the tragedy of World War II and

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[2] "…in particular the development of monetary unification must be based on sufficient progress in the field of convergence and then in that of the unification of economic policies. Parallel to the limitation of the autonomy of the Member States in the matter of economic policy it will be necessary to develop corresponding powers at the Community level." (p. 8)

[3] "…on the plane of institutional reforms the realization of economic and monetary union demands the creation or the transformation of a certain number of Community organs to which powers until then exercised by the national authorities will have to be transferred. These transfers of responsibility represent a process of fundamental political significance which implies the progressive development of political cooperation. Economic and monetary union thus appears as a leaven for the development of political union, which in the long run it cannot do without" (Werner Report, 1970, p. 12)

[4] "In the economic field a wide range of decisions would remain the preserve of national and regional authorities. …such decisions would have to be placed within an agreed macroeconomic framework and be subject to binding procedures and rules. This would permit the determination of an overall policy stance for the Community as a whole, avoid unsustainable differences between individual member countries in public-sector borrowing requirements and place binding constraints on the size and the financing of budget deficits." (Delors Report 1989, p. 14)

[5] "Such *imbalances might arise* because the process of adjustment and restructuring set in motion by the removal of physical, technical and fiscal barriers is unlikely to have an even impact on different regions or always produce satisfactory results within reasonable periods of time. Imbalances might also emanate from labour and other cost developments, external shocks with differing repercussions on individual economies, or divergent economic policies pursued at national level… None the less, such imbalances, if left uncorrected, would manifest themselves as regional disequilibria. Measures designed to strengthen the mobility of factors of production and the flexibility of prices would help to deal with such imbalances" (Delors Report 1989, p. 15) (emphasis in the original).

idealism to a technical process.[6] While this adjustment worked reasonably well for decades and produced wellbeing and political stability for Europeans, it nevertheless contributed to create an incomplete and unbalanced Eurozone paradigm. The Eurozone system paradigm is unbalanced, since it gives strong priority to fiscal stability and inflation control, while downplaying the real economy. The Eurozone paradigm is also incomplete, since it deals with the common currency and the hard budget constraint of public finances, but leaves out of consideration other fundamental economic and social institutions. Its inadequacy became evident during the crisis and led critics to ask whether introducing the euro too early, before the necessary accomplishments of political and fiscal integration and amidst incomplete institutions was wrong (Nuti 2015; Pisani-Ferry 2012; Rosefielde and Razin 2012).

Thus the basic reference frame for the Eurozone, the paradigm, is unbalanced and incomplete and therefore runs the risk of being ineffective as a guide understanding and for action, in particular in non-standard circumstances such as a crisis.

2. Kornai's contribution to systemic analysis: paradigms, systems and the Eurozone

Kornai defines a paradigm as a "long-lasting common way of thinking by a scientific community" (Kornai 2000, p. 113). Once defined and accepted, a paradigm "…provides a certain circle of researchers with the intellectual guidance that paradigms should provide" (p. 113). The paradigm is the outcome of a long intellectual and scientific development, to which various scholars of different generations contribute.

The system paradigm is a particular kind of paradigm which has a composite origin. A system paradigm refers to a paradigm with the following six attributes (Kornai 2000, pp. 118-121). First, researchers are concerned with the system as a whole and with the relations between the whole and its parts. Second, the attention of researchers is focused on the more permanent institutions and on system-specific attributes of the operation of a society. Third, researchers must search for an explanatory theory in historical terms. Fourth, individual preferences are considered as largely the product of the system itself. Fifth, researchers recognize that all systems have shortcoming or dysfunctions specific to them. Sixth, the characteristic research and analysis method is comparison.

The Eurozone paradigm is not the outcome of pure scientific analysis, so the use of the term paradigm may look unjustified in this case. Yet the system paradigm, in Kornai's (Kornai 2000, p. 123) words, "…is one that only half-meets the criteria of the strict scientific method". In fact, "…the methodology of the system paradigm lacks models based on exact assumptions and theorems…". However, "it requires of its exponents the consistency of logic, with statements supported by argumentation and comparison with similar or contrasting cases. The stringency of the argumentation is increased by quantitative analysis, which has to be done wherever possible."

[6] It is recounted that, when criticized by federalists for not going far enough, Delors defended his goals as pragmatic stating "we are all slaves to the circumstances" (https://en.wikipedia.org/wiki/Delors_Commission downloaded on 9 January 2018).

Is the "Eurozone paradigm" comparable to a system paradigm? My answer is affirmative for the following reasons. First, the evolution of the European Union is the outcome of scientific and intellectual effort, as much as it is of political and social interaction and determination. The construction of the Eurozone in particular was preceded and accompanied by much scientific research and reasoning. Researchers, politicians and social movements shared a particular, cooperative view of the integration process and came to share methods and procedures. The research that preceded and accompanied the construction of the Eurozone gathered many researchers and thinkers that afforded the same problem and approached it in similar way. Progressively, this generated a long-lasting common way of thinking that informed a large part of the scientific community dealing with monetary unification and the official European organs. The dominant view, thus provides many researchers and decision-making organs with intellectual guidance. Moreover, the Eurozone paradigm shares the six attributes proposed by Kornai for a system paradigm.

It is also important to clarify in which way the Eurozone can be considered to be a system. The term system "…conveys the meaning that several lesser parts form a coherent whole. These parts interact. …there are comprehensible relations among them organizing them into a structure." (Kornai 2016, p. 549). In economics, and particularly in comparative economics, the term is used to identify "…a distinct combination of forms of political power, dominant ideology, ownership relations, and coordination of social activities…" that distinguish a country or a group of countries from others and that evolved through time. Typical examples are the capitalist and the socialist system. Here the term "…points to the mutual effects of various elements in the public state of affairs, operation of the country, and structure of the machinery of power." (Kornai 2016, p. 549).

Primary characteristics mentioned above (political power, dominant form of property, and coordination mechanism) determine the system as a whole and are used to distinguish different economic systems. Along with these, there are six secondary characteristics that are determined stochastically by primary characteristics. They include the working of the goods and labor markets, technical progress, income distribution, microeconomic budget constraint, corruption (Kornai 2016, p. 553).

Clearly the Eurozone includes only countries with a capitalist system. Yet it is evident that there is a great deal of variety within this group of countries. Can the statement that Kornai refers to the socialist system be used also to explain the Eurozone? Kornai wrote: "despite all the individual attributes that distinguish each of these socialist countries from all the others, they resemble one another and exhibit important attributes in common. Even though their actual systems differ in many details, they are all members of a broader, clearly identifiable class of socio-political-economic systems…" (Kornai 1992, p. 5).

Since my problem is to understand the Eurozone paradigm and whether the Eurozone forms a system, it is important to assess how this unique paradigm impacts on an allegedly variegated group of countries. In fact, we can easily presume that a consistent paradigm foresees similar behavior of countries adopting it. If the paradigm were to concern only the broad primary characteristics the Eurozone system could work smoothly. This is indeed the case of the common market based on the four fundamental freedoms, albeit the ongoing negotiations on Brexit are showing how complex is even this less demanding integration.

The fact that the socialist system disintegrated is hopefully of no much help in the case of the Eurozone.

There are approaches that can complement Kornai's analysis and are useful to understand and analyze the "varieties of the great systems" (Kornai 2016, p. 562). I'll concentrate here only on the capitalist system as it exists in the Eurozone. I'll consider briefly three important contributions: by Kornai, the variety of capitalisms and its variants, and the new comparative economics.

While Kornai's primary aim is to distinguish the different variants of the outcome of the process of transformation of former socialist countries in capitalist countries, his approach is useful also to highlight the varieties existing within the Eurozone. Kornai's main organizing criterion is the politico-governmental form of different countries. He stresses "what a huge effect political structures and political ideas have, and how vital it is to examine in detail the course of history for an understanding of the transformations of society." (Kornai 2016). While Kornai refers to the shift from socialism to capitalism, these words can be fully applied to the other "great" change that monetary unification represents in the Eurozone. Yet the devil is often in the particulars and the two cases cannot be fully identified and have important, perhaps fundamental differences.

Kornai distinguishes between four primary characteristics of democracy, autocracy and dictatorship, and six secondary characteristics (Kornai 2016, p. 565). Based on these characteristics, all EU member countries are democracies, with the exception of Hungary, which is an autocracy. No member country is under dictatorships. Hungary is not a member of the Eurozone, which includes all democracies. Yet Kornai's analysis is interesting in a different sense. Eurozone member countries gave up an important part of their sovereignty, money, and accepted to limit their financial sovereignty, submitting it to commonly devised and shared convergence parameters and granting common bodies – the European Council and the European Commission in particular – the power of inspection and enforcement of common rules.

The fundamental problem, then, is to assess whether the governance of the European Union (EU), and even more so the Eurozone lack democratic legitimacy. Indeed, various authors theorize the existence of a "democratic deficit" in the Eurozone (Piattoni 2016, but see Moravcsik 2008). The problem is as follows. Democratically elected or appointed governments agreed to submit their country's sovereignty to a set of parameters whose compliance with is checked and enforced by an organ without a formal decision- or law-making role (the European Council)[7] and an organ set up through the interaction among national governments and only then formally approved by the democratically elected European Parliament (the European Commission).

More serious is the problem coming from the management of the common currency. The euro is a fiat money without a government. No member country in the Eurozone has its own

[7] The European Council is composed of the national prime ministers and is chaired by the president of the European Commission. Although the European Council has no decision- or law-making role, it is nevertheless the most influential European institution. Its main role is to define strategic issues, including changes in the Treaty, enlargement, the three-year budget, or other reforms of the Union.

currency and national finances are in a currency that national governments do not control, except very indirectly and minimally through the Governing Council of the European Central Bank.[8] Any decision by the ECB and any assessment by the European Commission can strongly restrict or even determine policy making by democratically elected national governments.

There are various examples of the problematic effects of the supposed democratic deficit on the life of member countries. The two most striking examples are perhaps the mistreatment of the Greek government in summer 2015 and the imposition of selected harsh austerity policies against the will of the democratically elected Greek government and the population. A second example is when, in fall 2011, the democratically elected government of Italy resigned following not-yet clear ploy at European level, apparently with domestic support. Yet in other cases the mechanism worked apparently the other way around: Germany and France did not comply with the excessive deficit rules and Germany and the Netherlands with excessive current account surplus without being obliged to do so.

These cases highlight the danger that a possible, mild democratic deficit is strengthened by asymmetric and unequal treatment of different countries, depending on their political power. This may jeopardize the neutrality of Eurozone rules, as a consequence of which the same rules may have quite different consequences for different countries. In any case, some member countries of the Eurozone may appear to have a limited democracy and others extend the power of their *domestically* elected governments over others through the Eurozone organs. Kornai's analysis offers important suggestions to assess the rules overlooking the decision making and working of the Eurozone organs.

3. Institutional efficiency and systemic variety

Kornai's analysis is important for understanding the cohesive nature of economic systems and for explaining the broad context of the nature and working of the Eurozone. Other approaches are useful to complement this picture. I deal here with the new comparative economics (NCE) and the variety of capitalisms (VoC) approach theory and its variants. Both approaches deal with different variants of the capitalist system and the reasons why fundamental public and private institutions differ systematically and significantly among countries. These approaches lead us closer to answer two fundamental questions. Is it possible to identify and choose efficient institutions (NCE)? Is it possible to make different varieties of capitalism share such a fundamental institution as the currency when other important constituents of those varieties are different (VoC)?

The "New Comparative Economics" (NCE) considers the comparative institutional efficiency properties of institutional and economic change and draws normative consequences for reform (Djankov et al. 2003, Shleifer 2002). In its explanation, fundamental institutions - the legal system and property rights – determine the efficient properties of

[8] The Governing Council of the European Central Bank is the main decision-making body of the ECB, responsible for formulating monetary policy for the Eurozone. It comprises the members of the Executive Board of the European Central Bank and the governors of the National Central Banks of the Eurozone's member countries.

change. This is a narrower and simpler approach than Kornai's holistic method and runs the danger of oversimplification, although it has the advantage of promising to find unambiguous solutions to the comparison of variants of the capitalist system (Brada 2009, Dallago 2004).

In the NCE vision, individuals have a natural inclination to subvert social institutions to pursue their personal gain. This generates a trade-off between disorder and dictatorship which the legal system is called to control and solve. For any given "law and order" endowment of a specific economy a particular legal regime is efficient. More precisely, a pure liability regime is efficient in conditions of law and order. In other conditions, a regulatory regime is efficient.[9]

According to NCE, "[t]he theory leads to predictions as to what institutions are appropriate under what circumstances." (Glaeser and Shleifer, 2003, p. 401). This could provide the possibility to assess the construction of the Eurozone in the light of the NCE, thus clarifying the efficiency rationale for different national legal regimes within the Eurozone. It seems fare to suppose that the NCE approach leads to conclude that the economic and monetary union is not efficient. It also clarifies the rationale for the supposed bureaucratization of the Eurozone and its democratic deficit.[10]

The Varieties of Capitalism (VoC) research concentrates the comparison of economic systems to the microeconomic level. For this it is particularly apt to analyze the problems of the Eurozone from a more disaggregated perspective (Amable 2003, 2016; Hall and Soskice 2001; Kapás 2013; Morgan and Whitley 2012; Tridico 2011). Rodrik (2011, p. xviii) provides a clear introduction to the microeconomics of economic systems and the rationality of institutional variety: "[e]conomic prosperity and stability can be achieved through different combinations of institutional arrangements in labour markets, finance, corporate governance, social welfare, and other areas. Nations are likely to - and indeed are entitled to - make varying choices among these arrangements depending on their needs and values".

VoC highlights that different countries have different institutions and distinct organizations of their economies which form different forms of capitalism. These work in different ways. The institutional and organizational foundations explain why these varieties cannot be easily changed or converge. One important reason is that different institutions bundle in a coherent way around distinct and recognizable patterns, i.e. economic systems which move along particular paths of institutional change (Hall and Thelen 2009). However, and important for the issue discussed in this paper, the allocation of particular countries to one particular type

[9] NCE defines comparative institutional efficiency by a diagram relating the two fundamental costs of social economic life, disorder and dictatorship, relative to a world with perfectly defined and enforced property rights. Disorder is made of social losses due to private expropriation and dictatorship includes social losses due to state expropriation. The institutional possibility frontier (IPF) is a convex isoquant reflecting how much disorder can be reduced with an incremental increase in the power of the state. In this framework, an institution (e.g. a legal or regulatory system) is a point on the IPF. The IPF defines, in its point of tangency to the total loss minimization function, the efficient institutional choice for a given society or sector. Societies with a high level of civic capital are better capable of achieving cooperation among their members, which is represented with an IPF closer to the origin.

[10] An important strand of literature, rather similar in the approach to NCE, considers the relation between culture, institutions and economic performance (Acemoglu and Robinson 2012, Tabellini 2010).

of capitalism is not necessarily stable may change through time under the influence of different factors (Schneider and Paunescu 2012).

VoC scholars have initially identified two distinct economic systems: the liberal market economies (LME) or Anglo-Saxon system and the coordinated market economies (CME) or Continental European system. The former is typical of Great Britain, along with the United States, while the latter has Germany as its most representative country. Most countries of continental Europe can be ascribed to different variants of the latter system. However, others belong in what is usually termed a mixed or Mediterranean market economies (MME). The main differences between different varieties of capitalism relate to financial systems, labor markets and welfare systems.

According to VoC literature, financial markets in the LMEs are dominated by risk capital, while in CMEs it is debt capital that occupies the most prominent role in the economy. Overall, financial markets are more important and more liquid in LMEs than in CMEs. In the latter the state has a greater role in financial markets (Bouis *et al.* (2013).

Important differences between LMEs and CMEs also exist in labor markets. Flexibility of entry and exit is usually greater in LMEs, while seniority contracts, firm specific investment and alternative instruments of flexibility such as reduced working hours are more important in CMEs, thus making the latter less reactive to financial shocks and more stable (Chilosi 2012; Goergen et al. 2012; Walker et al. 2014). In MMEs these instruments do not exist or are less effective, which causes labor re-allocation to be slow and youth and long-term structural unemployment high. Overall, the mobility of resources is higher in LMEs than in CMEs (Davis and Haltiwanger 2014, Kahanec 2012), which makes regulation more complex and difficult in the former, although also more important for the smooth working of financial and labor markets.

VoC also highlights the tendency of different systems to have dissimilar approaches to public finances and government spending, whereby CMEs have stronger preferences for government activity and governance matters (Ahrens 2015). CMEs do not generally spend more than LMEs and spending in the former increases with better governance only.

There appear to be differences between LMEs and CMEs also concerning counter-cyclical budget policies. The standard VoC explanation is that LMEs and CMEs respond in different ways to macroeconomic shocks through fiscal policies (Soskice, 2007). In particular, due to their many differences mentioned above, the former feature a more active stance and are more determined in activating counter-cyclical discretionary government spending than CMEs. However, Amable and Azizi (2014) test the hypothesis in the case of 18 OECD countries between 1980 and 2009 and find that discretionary fiscal policy has been more counter-cyclical in CMEs than in LMEs.

These hints show how the VoC literature may offer important analyses and suggestions for understanding and managing the Eurozone problems in general and during the crisis in particular. The latter issue was analysed by two recent papers. According to Nölke (2016) the Eurozone crisis has purely systemic causes and descends from the monetary union implemented in institutionally heterogeneous economies, while the behavior of individual member countries is not to be blamed. More specifically, the crisis was caused by four mechanisms. These are the working of labor markets, in particular the absence of a system of coordinated wage bargaining as responsible for the loss of cost competitiveness. Moreover, the Eurozone is mostly specialized in medium-quality goods with high price elasticity. In this type of market, the competition of emerging market economies is strong and growing and has caused a loss of market shares for Southern Eurozone economies. While weak innovation in these economies could not improve on the loss of competitiveness, the latter has been masked temporarily by the strong increase of public debt and by household debt.

Johnston and Regan (2016) base their analysis of the European Monetary Integration on the concept of the incompatibility between national varieties of capitalism. According to these authors, two different models co-exist within the monetary union: the export-led growth model typical of the "euro core" and the domestic demand-led growth model of the "euro periphery". Before monetary unification these two models could co-exist, thanks to the presence of two inflation adjustment mechanisms in the exchange rate: the nominal exchange rate in soft currency regimes of the future euro periphery and national central banks' promotion of inflation convergence in hard currency regimes. Thus external imbalances between these two growth regimes, so typical of the Eurozone, did not emerge prior to EMU. As far as increasing divergences in external balances have emerged between these two models, these growth models have become increasing incompatible.[11]

4. The consequences of paradigm incompleteness and systemic duality: The Eurozone as an incomplete contract

The euro, the legal tender in 19 EU member countries, is a fiat money. A fiat money is a currency which has value only by government order. However, the euro is a fiat money without a state. The euro does not even have a complete government. In fact, it is sovereign governments that agree to give up their monetary sovereignty and establish the euro as their sole and common currency. They delegate the European Central Bank (ECB) as the only repository of the monopoly to issue money.

These same governments keep their institutional and policy sovereignty in all other field, in which they simply agree behave in a way compatible with monetary stability, first among these is financial stability. To do so, and provide other member countries with credible commitments, they base their government activity on convergence criteria, properly checked and enforced by third parties (the European Commission and the European Council). Although so far this commitment was not seriously tested – with the partial exception of the case of Greece in summer 2015 – it is not certain that a member country cannot leave the Eurozone, if it has a strong will to do so. The fact that this is not foreseen in the European treaties may not be a sufficient guarantee in cases of extreme tensions.

[11] The World Economic Forum (https://www.weforum.org/reports) provides a quantification of differences among countries, including Eurozone countries in 'The Global Competitiveness Report' and 'The Europe 2020 Competitiveness Report'.

The euro is thus established as an incomplete inter-country (inter-government and inter-state) contract among otherwise sovereign countries, which voluntarily accept to submit their financial behavior to commonly devised and enforced parameters. This is a novel undertaking, that has no other examples in the history of any other currency. While it is natural that under such circumstances there are many unforeseen events and much uncertainly on the proper way to afford these events, the institutional and policy incompleteness of the monetary union is bound to create serious problems. The Werner Report had a clear vision of this[12] and a clear perspective for the solution[13], yet to come.

The process of building up a European common currency area, as presented in the Werner Report, was based on the necessity of both real and financial convergence, along with policy convergence. However, the instability caused the disruption of the Bretton Woods system and the oil crisis prompted European countries to adopt different national policies to react to the shocks, which slowed down the process to monetary integration. The 1974 Council Decision on economic convergence and the fundamental Delors Report of 1989,[14] however, started to move in the direction of financial convergence, while paying lip service to the necessity of real economic convergence. This perspective was finally made operational in the Maastricht criteria, entered into force in 1993, and the Stability and Growth Pact of 1997.

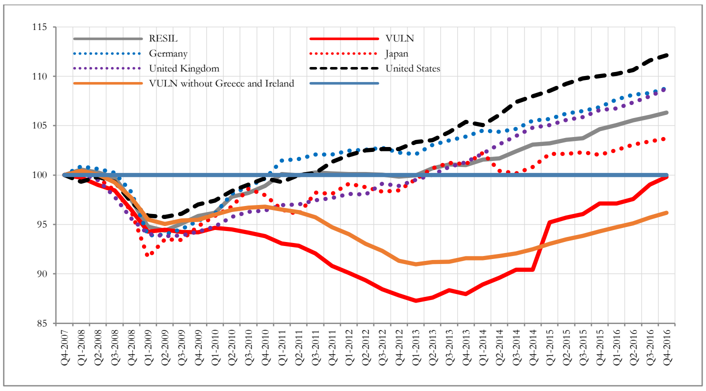
The outcome of this process was that, precisely because of economic divergence, member countries have to stick to the behavioral rules stipulated in common agreements. However, the concept of policy convergence remained unclear and the way for pursuing economic convergence remained in need of elaboration. What remained unsolved, in particular, was whether and how it is possible to have common or at least compatible policies for member countries in deeply different real and financial conditions and situations and different systems. What was stipulated in these documents, partially disregarded in the happy times of the introduction and take off of the euro, became paramount during the crisis and led to the supreme goal of financial stability to the cost of all the rest. Economic performance started to diverge significantly (Chart 1)

[12] "…the advances towards integration will have the result that general economic disequilibrium in the member countries will have direct and rapid repercussions on the global evolution of the Community. The experience of recent years has clearly shown that such disequilibrium is likely to compromise seriously the integration realized in the liberation of the movement goods, services and capital." (Werner Report, 1970, p. 8).

[13] See footnote 3.

[14] In Section 4.11 of Chapter 1 of the Delors Report (1989, p. 11) it is observed that "Although substantial progress has been made, the process of integration has been uneven. Greater convergence of economic performance is needed. Despite a marked downward trend in the average rate of price and wage inflation, considerable national differences remain. There are also still notable divergences in budgetary positions and external imbalances have become markedly greater in the recent past. The existence of these disequilibria indicates that there are areas where economic performances will have to be made more convergent." In Section 3.50 on "The principal steps in stage one" (p. 30) it is stated that "Stage one represents the initiation of the process of creating an economic and monetary union. It would aim at a greater convergence of economic performance through the strengthening of economic and monetary policy coordination within the existing institutional framework. In the institutional field, by the time of the transition to stage two, it would be necessary to have prepared and ratified the Treaty change."

Chart 1. Quarterly GDP, Percentage change over previous period (Q4 2007=100) [15]



In consideration of the treaties concerning monetary unification and its implementation and evolution, the euro is based on an irreversible incomplete contract among politically sovereign countries. Incompleteness creates uncertainty and consequently the danger of moral hazard in the relation among member countries. Moral hazard and uncertainty lead to the predominance of short-term goals and achievements, primarily short-term balanced budgets. A rational adaptation to such a situation, the best way to keep moral hazard under check, is to impose hard budget constraints across the board, in particular to national finances and the ECB mandate. A corollary is to avoid the existence of common resources to be used in times of stress, a common budget.[16]

This solution is quite rational in an institutionally and policy incomplete monetary union, but is not efficient. Worst, one currency with a unique exchange rate plus hard budget constraint on national public finances and no compensating mechanisms causes divergent internal performances even if market processes (the private insurance mechanism) would work to reduce divergence. In fact, convergence parameters were not really effectively enforced and market resources flowed to countries in greater need (vulnerable countries). However, when the crisis alarmed the Union and the national governments of resilient countries, the enforcement of parameters became hard and private resources duly escaped vulnerable countries.

An irreversible incomplete contract among politically sovereign countries leaves a broad discretionary area and creates uncertainty and the danger of moral hazard. Since this outcome prevents cooperation and may cause conflict among member countries and between these and common organs – both extremely dangerous for the common currency - complete

[15] Vulnerable countries (VULN) are those member countries of the EU which, due to their difficult economic or financial position (such as having an uncompetitive economy or being in an unbalanced macroeconomic or financial situation, or both), need to strengthen and adjust their situation by means of policies. However, they miss policy sovereignty to do so following their membership in an incomplete monetary union. Conversely, resilient countries (RESIL) have balanced finances and competitive economies and do not need policies to adjust their economies. In the chart, vulnerable countries are Cyprus, Greece, Ireland, Italy, Portugal, Spain. Vulnerable countries are Austria, Belgium, Finland, France, Germany, Luxembourg, the Netherlands.

[16] Indeed, the modest EU budget (corresponding to a bare 1 percent of the EU GDP) is not a budget for helping countries in liquidity crisis, but one for supporting disadvantaged areas (regions, agriculture). The Eurozone has no budget of itself.

governance is needed. Complete governance requires proper institutions and the allocation of discretionary power to a third party. The imposition of hard budget constraint in the short-term over public finances is the easiest and more controllable way of keeping uncertainty and moral hazard under control. The problem of the Eurozone is fully here and the crisis proved beyond doubt how dangerous it is to disregard this simple truth.[17]

5. Assessment

A definition of a scientific and technical paradigm preceded and accompanied the actual construction and development of the Eurozone. This paradigm was expressed in various documents and theories on the European monetary integration and models and analysis of the Eurozone. The paradigm purposefully foresees an incomplete integration that has at the core the common currency, but extends to other fields only insofar as coordination, integration and eventually the transfer of competences from national governments to common organs is considered fundamental for the stability of the common currency. The paradigm developed pragmatically through the test with reality, in particular during the international and European crisis. However, so far this concerns primarily the financial and monetary sectors.

The Eurozone paradigm is logical, yet unbalanced and incomplete. Moreover, if one looks at the policy proposals which circulate in the Eurozone and elsewhere, it may appear that there may be two different and competing approaches. For simplicity, I'll call one the mainstream policy approach and the other one the neo-Keynesian policy approach.

In a nutshell and perhaps oversimplifying, the mainstream policy approach reads the part of the Eurozone paradigm that deals with the need to have balanced finances in each member country.[18] This is in contrast with the Werner Report (1970)[19] and even the Delors Report (1989), but much in line with the popular reading of the Maastricht agreement, although not the Treaty. While having balanced national finances is fundamental for the ongoing cooperation and trust among the member countries of an incomplete monetary union, such

[17] This situation recalls an important conclusion that Kornai (2014, p. 68) reaches in his analysis of capitalism: the fundamental working of the system (structural surplus of supply) comes mainly from the intrinsic interest of firms' owners and managers to keep costs low, in spite of the common interest to expand demand via higher incomes. One can replace the firms with member countries and costs and incomes with fiscal balances and the conclusion fits well the Eurozone.

[18] See e.g. Sinn (2014) and the position of German economists in the debate on the nature of Target2. The ECB position, as expressed by its president Mario Draghi (2014) is particularly interesting and expresses a systemic view: "… if we do not want a transfer union, then we have to be consistent and establish an environment where other mechanisms can work.

This means, first, advancing with the agenda of the new Commission President to establish a genuine Capital Markets Union in Europe. And second, establishing a genuine Economic Union in parallel. If countries are to attract capital and benefit from financial risk-sharing, then it has to be attractive to invest there. And this can only be achieved if, over the medium-term, all countries have sufficient adjustment capacity and growth prospects.

Yet even with full implementation of these Unions, we could still not call EMU complete. We also have to acknowledge the crucial role that accrues to fiscal policies in a monetary union."

[19] See section 1 of this paper.

balance can be reached in two different ways: by imposing a hard budget constraint in the short run or by balancing finances through growth and competitiveness, which corresponds to balancing the budget in the long run. Sometimes these two goals fit together, although under different circumstances they do not. So far in the Eurozone they failed overall to balance and the quality and behavior of flows of private resources neither promoted growth nor financial stability, but often promoted the creation of financial and real estate bubbles. Thus this reading of the Eurozone paradigm boils down to the short-run interest of financial stability.

Dissimilarly, the neo-Keynesian policy approach, particularly after the start of the crisis, proposes that public budgets are used to revitalize growth.[20] This means suspending or cancelling convergence parameters. It also supposes that countries, particularly resilient ones, agree to extend joint support to vulnerable countries, based on trust and without any threat of moral hazard, thus de facto easing their budget constraint. In this they overlook that vulnerable countries typically failed to reform and stabilize their economies in due time and delayed reforms also afterwards. Some versions of the VoC theory have convincingly explained why they failed to do so, so this failure may be the outcome of factors other than the lack of determination and goodwill.

Much more could have been done at Eurozone level to provide better coordination in due time and set up common resources for supporting countries with liquidity problems. It was believed that the IMF was sufficient and more credible in doing so, without running the danger of having a Eurozone fund under the threat of political bargaining. Deficit spending policy at national level was simply not viable in an incomplete monetary unification, because this would have exported problems to all the other countries or, if causing inflation at home, would have diverted demand to other countries, thus neutralizing the domestic effect.

A more reasonable alternative was pretending that surplus countries, Germany in particular, expand their domestic demand to create domestic expansion and create this way demand also for vulnerable economies. A particular version of this approach was proposed by the US Department of Commerce in 2013, which strongly criticized Germany for failing to do so and continuing to pursue a sizeable current account surplus.

A fundamental shortcoming of the original Eurozone construction and the Eurozone paradigm is that it takes for granted an external context characterized by fundamental stability and continuous economic expansion. While the paradigm as expressed in its fundamental documents pays due recognition to the importance of the real economy and its growth, this is basically left to national governments and to the driving force of globalization. The Eurozone worked apparently well during its first years, but tensions accumulated already before the crisis (Dallago et al. 2016). However, it was the crisis that revealed beyond doubt that the paradigm is dangerously unbalanced and incomplete and that the kind of Eurozone cooperation and instruments it foresees are insufficient.

[20] This position is prominent in the works by the European trade union association "Social Europe". See e.g. Herr et al. (2017).

6. The Eurozone problem

The Eurozone problem is, pragmatically, to have a set of institutions and organs that make possible to run properly a common currency in a group of countries which keep substantial sovereignty in many field and intend to do so for a long time ahead. The problem is well known and it is made of two components. First, when a political or economic formation – be it an empire, an economy or a transnational company - includes parts which are quite different or operate in different contexts there is the well-known problem of asymmetric effects of unique and uniform central decisions or orders, along with asymmetric information. Decentralization – federalism or multi-divisional organization alike - is the typical solution, which keeps only strategic decisions in the hands of the center (central government, CEO).

Second, the aspiration of the parts to autonomy cannot be repressed for long, even in empires conquered by force. In transnational companies it is a fundamental organizational strategy to adapt the organization and management of affiliate companies to local features and standards. The problem is more daunting in a club of voluntary members, such as the Eurozone is, in which each member accepts to give up only part of the sovereignty, but is the jealous custodian of most other types, while there is no supreme commander.

The challenge for the Eurozone is to combine the advantages of the common currency with the historical legacy of a group of countries each willing to keep political, economic and social idiosyncrasies. The problem derives from the particular nature of money. While the integration of markets or customs unions require only few common norms (e.g. avoid state help to firms, practices of unfair competition, identical customs duties), money needs one central institution for all countries. Yet money cuts across-the-board in that it influences all economic (and social and political) activities of a country.

Lacking political integration, i.e. a common government, the definition and the construction of the Eurozone can only form an incomplete system. This opens a critical question: how can such a system work? The system includes the coordinated set of all relevant formal and informal institutions and organs necessary to operate them. As such, the system must be complete to coordinate the activity of economic and social actors, provide incentives, generate information flows and lead to proper decision making, organize production, manage uncertainty and conflicts and solve them. Indeed, the system shaping Eurozone countries is complete; however, the common system of the Eurozone and the system of each member country are incomplete. The Eurozone system is thus a double level system, since it includes both what is common and what is national. Hence, the allocation of precise competences and the coordination between the two levels are fundamental and the risk of ambiguity is pervasive.

The common level includes monetary institutions and organs, which are identical for all Eurozone member countries. Moreover, as members of the EU, Eurozone member countries share the EU approach in the allocation of competences other than on money. The EU has exclusive competence in a number of important fields.[21]The national level includes

[21] These include: customs union; competition in the internal market, including establishing the relevant rules, their enforcement and the control over potential anti-competitive situations and practices; within the Eurozone, design and implementation of monetary policy; the common commercial policy; and the common

the parts of the national systems for which national sovereignty continues to hold (e.g. welfare, legal matters, the pension system, police, administration). The Union in this case has coordination and supportive roles and no common legal organs has competence over these matters.[22] Finally, various competences belong in some way in both the common and the national level,[23] following the fundamental EU principles.[24] This system is certainly cumbersome and open to conflicts and administrative red tape. Moreover, member countries had different starting conditions, including the monetary and fiscal domains, and different goals from monetary unification, which made coordination more complex. However, the common political determination to cooperate, prevailing in all countries, helped the working of the dual level system.

If markets were perfect, having a well working system would be less important. If there were no transaction costs to economic activity, if resources were perfectly mobile and substitutable, if the allocation of resources were always to the socially most productive use, if national borders were not mattering, if countries were sharing exactly the same goals and ideals, if decision makers were perfectly rational and forward-looking, then the Eurozone were a perfect optimum currency area (OCA) and a Eurozone system would be irrelevant.

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fisheries policy, including the conservation of marine biological resources. In addition to these competences, the EU is also solely responsible for those international agreements whose conclusion is foreseen in a law of the Union or is necessary for the exercise of the Union's internal competence, or in cases when the international agreements affect common rules.

[22] The Court of Justice of the European Union has supranational jurisdiction over European legal affairs. It intervenes particularly in the disputes between member countries, between the EU and member countries, between EU institutions, and between individual citizens and the EU.

[23] Shared competences between the Union and national governments include the internal market; social policy, for the aspects that are defined in the Treaty; issues of economic, social and territorial cohesion; agriculture and fisheries matters; the environment; consumer protection; transport; trans-European networks; energy; issues of freedom, security and justice; and common safety concerns in public health matters. Parallel competences of the Union and national governments include research, technological development and space; and development cooperation and humanitarian aid. When competences are parallel, the Union carries out activities and conducts common policies that coexist with the exercise of similar competences by the member countries. Coordination of national competences include economic policies, when the European Council adopts guidelines for these policies and other measures, employment policies and social policies of the member states. In all these cases, the guidelines that member countries are required to follow are defined at the Union level, including through treaties (convergence criteria) and pacts (SGP). Finally, some of the Union's competences are supportive of those of the member countries, in the sense that the Union carries out actions for supporting, coordinating or supplementing the action of the member countries. These include competences in the protection and improvement of human health; industry, culture, and tourism; education, vocational training, youth and sport; civil protection; and administrative cooperation.

[24] The structure and distribution of competences between the Union and the member states is defined in the Treaty of Lisbon and is based in the principle of conferral (Article 5 of the Maastricht Treaty). The principle provides that the Union acts only within the limits of the competences conferred upon it by the member states in specified areas. Another important piece of the distribution of competences and decision-making is the principle of subsidiarity. The principle is defined in Article 5 of the Maastricht Treaty, which stipulates that decisions are taken as closely as possible to the citizens. Except in the areas that fall within its exclusive competence, the Union proceeds only in those cases where its action is more effective than action taken at national, regional or local level. Even in these cases, the Union is bound by the principle of proportionality. This principle stipulates that any action by the Union should stay within the limits of what is necessary to achieve the objectives of the Treaties. However, the Union's competences may be extended through the application of the flexibility clause. This clause is defined in Article 352 of the Lisbon Treaty and may be activated when the Treaties do not foresee the means necessary for achieving one of the Union's objectives.

The Eurozone reality is well less than perfect. Even an imperfect OCA such as the United States fares clearly better than the Eurozone under most of the critical variables of an OCA (see chart 2). However, this fact does not in itself prevent the possibility to have a working monetary union, if the monetary union acts as a shock absorber.[25]

Chart 2. Optimum currency areas compared

OCA criterion	Eurozone	United States
Labor mobility (Mundell)	Low	Yes
Trade openness (McKinnon)	Yes	Yes
Product diversification (Kenen)	Yes	Yes
Fiscal transfers	Low	Yes
Homogeneity of preferences	Partial	Yes
Commonality of destiny	Partial	Yes

Source: Own elaboration

In a doubtful OCA the smooth and effective working of the economic system is all the more important. There was and still survives in the Eurozone a belief that under harder budget constraint the vulnerable countries would converge to the same virtuous behavior or resilient countries. Comparative economics of different types suggest that this reading is superficial when the economic system is unbalanced and incomplete. If countries are different for reasons other than fiscal behavior – if their national systems differ - placing the common currency under the same formal Eurozone institutions, including hard budget constraint, must disadvantage the countries whose "normal" national behavior is farther away from the one upon with the monetary unification is based. If these countries are disadvantaged, their distance from the core "virtuous" countries is bound to increase.[26]

This is a case of implicit discrimination (Bertrand *et al.* 2005; Stiglitz 2012, p. 69). While formal European institutions are careful in avoiding any discrimination among member countries, the actual construction of the Eurozone and the daily practice may be different. Implicit discrimination is "*unintentional* and outside of the discriminator's awareness" (Bertrand *et al.* 2005, p. 94), yet it has real consequences. While conscious discrimination has well-known negative economic, social and psychological consequences, implicit discrimination influences behavior in different and subtle ways.[27]

[25] Mundell (1973) considers that asymmetric shocks do not undermine the common currency, which acts as a shock absorber. Indeed, the currency union spreads the shocks by allowing the negatively hit region or country to rely on the resources of the rest of the union, thus spreading the effect of the shock over a much larger area.

[26] The literature on transplanted institutions offers an interesting hint on this mechanism (La Porta et al. 2008). It shows that the introduction of alien institutions renders an economic system unbalanced and ineffective, which causes inefficiency of economic activity. While this analysis refers usually to former colonies, the process is similar in many ways to what happens in the Eurozone: without external colonization, but voluntarily submitting countries to alien institutions.

[27] … [M]any seemingly controllable behaviours may be prone to implicit attitudes under conditions of ambiguity, and … implicit discrimination is more likely to occur in situations where multiple, non-racist explanations for the behaviour might exist. Thus, some conditions under which implicit attitudes may arise are threefold: inattentiveness to task, time pressure or other cognitive load, and ambiguity. (Bertrand *et al.* 2005, p.

It seems possible to extend this psychological concept to Eurozone member countries. An unbalanced and incomplete system paradigm and a double level system create ambiguity which is easily a source of implicit attitudes in conditions where multiple motivations may exist for governments' behavior, Eurozone and national. If the Eurozone and the national good do not coincide in the behavior of individual countries, at least in the short run, the imposition of hard budget constraint streamlined to the Eurozone situation is likely cause implicit discrimination to the disadvantage of vulnerable countries.

Indeed, all other conditions remaining equal, a vulnerable economy, sharing the same currency with resilient economies, meets an internal appreciation of the real exchange rate. In order to counteract this effect, that jeopardizes its competitiveness, the vulnerable country can only use internal devaluation, i.e. decrease directly wages and other costs. Even leaving its distortive effects on incentives and political effects aside, internal devaluation shrinks the domestic market.

7. The internal divergence of an unbalanced Eurozone

The most evident, problematic and long-lasting effect of the situation depicted above is the growing internal divergence of the Eurozone between vulnerable and resilient countries. This divergence is increasingly evident not only in the nature of national institutions and in the behavior of countries, but also in their economic situation and performance. However, economic systems and economies may change through time.

Take the example of Italy. VoC places Italy in the mixed or Mediterranean model and stresses the political nature of its system. In Kornai's words, this corresponds to a prevailing soft budget constraint, which also explains the high public debt of the country. Yet this was not always so: in the 1950s and the 1960s, the Italian lira was a strong and stable currency, able to keep a fixed exchange rate within the Bretton Woods system.[28] Moreover, until mid-1960s, when full employment was reached, wages increased less than productivity and prices were very stable. During this period the Italian economy expanded and modernized rapidly in a process that is known as the Italian economic miracle. The following years were different and the drift of the Italian economy became evident particularly in the 1980s.

It is not the place here to enter into details, but to stress the core issue: the economic system and the situation of a country can change. This convincement led Italian authorities in the 1990s to try to invert the apparent financial drift. First was the Bank of Italy, the Italian Central Bank, which linked the lira to the German mark within the European Monetary System (EMS), in the convincement that this would have pushed Italian enterprises to gain competitiveness through investment and innovation and not through the support of the public budget and currency depreciation, as was typical in the 1970s and 1980s. The policy

95) A parallel with the Eurozone, in particular during the crisis, comes to mind. The crisis imposes, particularly in moments of greater dangers, time pressure and stress and thus generates an acceleration of the mental process in decision-makers, which generally lead to cognitive load and simplification.

[28] An international committee established by the Financial Times declared the lira as the best currency of 1960 (Mori 2009, p. 288)

failed: enterprises did not comply with this goal, which led to the momentary exit of Italy from the EMS and the massive depreciation in 1992.

Following governments led progressively back the country to the EMS first and the Eurozone then, convinced that this was the only way to push enterprises to gain competitiveness through investment and technical progress and to decrease public debt through both hard budget constraint and the lower interest rates that this was expected to create once the country was in the Eurozone.

The irony is that public finances reacted fairly well to this program, public deficits were put under control (from 6.7 percent of GDP in 1996 to 2.9 percent in 1997) and remained successively within the convergence criteria in the following years. Public debt decreased from 124 percent of GDP in 1996 to 100 percent in early 2000s. While following governments inverted these achievements through a U-turn of policies, it was also an important part of the private sector that reacted to the government's program by freezing or decreasing investment. The Italian economy started to retreat in its international specialization towards more mature and stagnating branches while its large companies started to fade away.

Another good example is Germany, which was labeled by the Economist as the sick man of Europe in early 2000s. However, the German economy improved remarkably in the following years, mainly thanks to the Hartz reform of 2004, which successfully made the economic system of Germany, in particular the labor market, more effective. This suggests a possible solution of the present dichotomy within the Eurozone between vulnerable and resilient countries: reforms and investment. It also suggests that causes should be looked for in two sources: the unbalanced and incomplete nature of the Eurozone paradigm, which generated a double level system, and the failure of vulnerable countries to reform their national (incomplete) systems and upgrade their economies though investment and technical progress.[29]

The problem is: why did some countries reform and other countries did not reform or did so in a sufficient way? The Eurozone put much pressure on vulnerable member countries to reform, these countries complied with in part, but these reforms apparently did not work and in some cases they could have even worsened the economic and financial situation, let alone the social and political situation.[30] One problem is the blurred meaning of the term reform and their problematic nature.

Even in cases of strong will and technical expertise reforms are often problematic for different reasons:[31] they may create uncertainty, they may cause too many losers, they generally impose sacrifices and costs in the short run in exchange for advantages and gains in the long run (the intertemporal problem). This may create a complex problem of collective action, that may be overcome by external pressure and/or support (Greece), by the

[29] Greece after 2015 may offer another positive example of systemic change.

[30] One of the reasons is certainly the changed value of the fiscal multiplier in a crisis (Blanchard and Leigh 2013)

[31] See Kornai (1986) and his many publications on transformation in Central-Eastern Europe. For an interesting political economy analysis of reforms see Bönker 1999 and Müller 2006.

reputation of reformers and a cohesive society (Germany) and by the existence or lack of devices and structures, such as a well-developed and financially sound welfare system, that may attenuate social costs (Germany). The lack or ineffectiveness of any of these factors is likely to slow down reforms or frustrate the effort (Italy).

In fact, reforms are costly in the short term and promise advantages in the long run. They present a problem of the inter-temporal, and often inter-generational allocation of costs and advantages. Yet in the Eurozone there is the additional problem of the intercountry allocation of costs and disadvantages. Countries that have to reform the most, i.e. that have to bear the greatest costs and face the most difficulties, are the countries that suffered most at the institutional level, in particular through the loss of the exchange rate adjustment.

Yet structural reforms are fundamental. There is international agreement, strongly supported by the EU and international organizations such as the IMF, the World Bank and the Organisation for Economic Cooperation and Development (OECD), that the revival of vulnerable countries needs structural reforms. According to the European Commission, structural reforms are fundamental, since they address obstacles to the fundamental drivers of growth.[32] Reforms, in this view, coincide with the liberalization of labor, product and service markets, in the belief that this would strengthen competition, encourage an economy's job creation and investment, improve productivity and in the end enhance competitiveness, growth potential and adjustment capacity. However, the accent was places mainly on changes to the labor market or the pension system in order to decrease production costs, ease dismissals and decrease public expenditures. There is no clear evidence that these changes improve the microeconomic efficiency and effectiveness of European economies. Moreover, these changes contribute to decrease the size of the domestic market and worsen incentives and the economic, social, and political mood of most consumers.

Other reforms, in particular decreasing transaction costs (e.g. administrative costs and costs of contract enforcement) and decreasing the tax wedge over economic activity (e.g. broaden the tax base through fighting tax evasion) are mentioned, but are rarely the focus of policymaking. Other important reforms are improving productivity by more and better investment, liberalization and more competition, research and development (R&D), improving the quality of human capital, strengthening innovation, including social innovation, leaner and more efficient public administration, more effective justice. These were important components of the Lisbon strategy and play an important role in the Europe 2020 strategy, so far without much actual importance, let alone priority.

Structural reforms are certainly essential, in particular for vulnerable countries and address fundamental reasons for their vulnerability. The problem with these reforms, however, is not in their nature or importance, but in the way they are proposed and implemented. As a matter of fact, they are urged more as a precondition for internal devaluation than for their intrinsic

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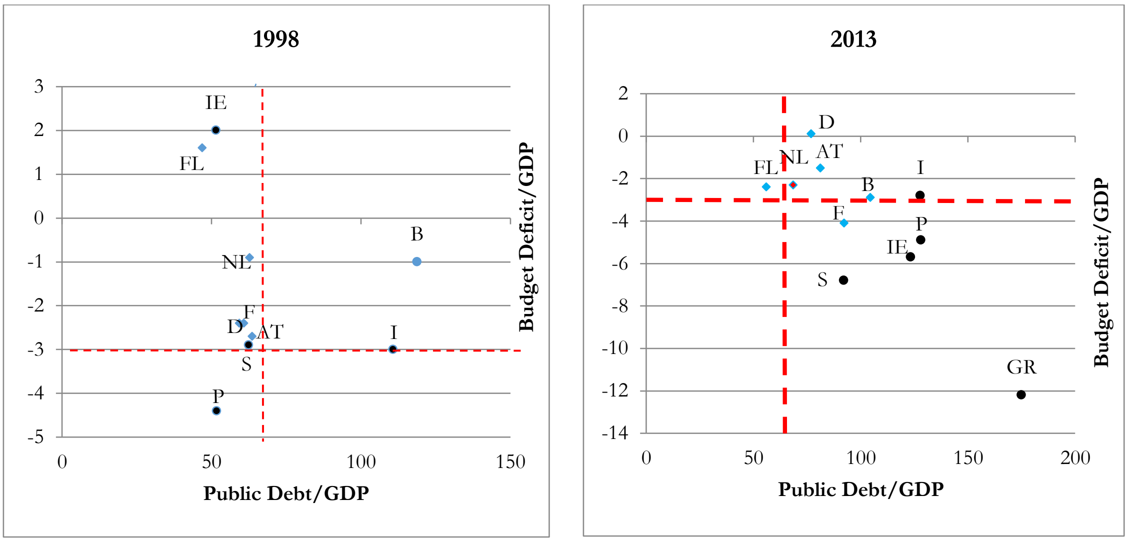
[32] EC (2015). According to the European Commission, structural reforms address impediments to the fundamental drivers of growth by unshackling labor, product and service markets to foster job creation, investment, and productivity. These reforms aim to enhance an economy's competitiveness, growth potential and adjustment capacity. See also Canton *et al.* (2014). As a matter of facts, in vulnerable countries the policy accent is mostly, sometimes nearly exclusively on labor and often on decreasing the remuneration and rights of employees. A similar definition is used by Alesina *et al.* (2008). See also OECD's *Going for Growth*, which also explicitly considers reform of taxation, public administration and civil justice.

importance. While this pressure, and their being part of conditionality packages in exchange for financial support, may be important to overcome a national stalemate and foot dragging, requests for structural reform tend to overlook other important aspects. The pressure on structural reforms and internal devaluation led to disregarding the more fundamental need for institutional reforms. Indeed, these became even more difficult, since the necessary financial resources were lacking. Moreover, due to austerity public investments were cancelled or postponed, while private investments were depressed by the falling demand by both private consumers and public administrations, both victims of austerity.

Balanced economies and finances, stronger investment, solid welfare and reforms implemented before the crisis made some countries resilient. Unbalanced economies and finances (either public or private or both), ailing investment, weaker welfare and lack of reforms when those were easier to implement made the performance weaker. This created a particularly serious situation in the Eurozone, since the two groups of countries trade intensely, have organs in common and share the same currency. A perhaps unwanted effect of the strength of the former compared to the weakness of the latter was that the former outcompeted the latter in the Eurozone market, thus exacerbating the latter difficulties.

While before the crisis the free flow of financial resources, much less so labor, in the Eurozone compensated the disadvantage of vulnerable countries, this did not solve the problems. On the contrary, sometimes it contributed to their worsening and losing time. The abundant inflow of private resources to vulnerable countries went often wasted in socially unproductive ways, including the production of real estate bubbles. Moreover, easy money took away pressure from balancing public and private budgets. Budget deficits continued to remain mildly controlled, due to the softness of the implementation of convergence parameters. High public debts failed to decrease. Wages and salaries increased more than productivity, while consumption expenditures converged to the resilient countries higher level, to the cost of savings. This worsened the sustainability of growth and worsened the competitiveness of vulnerable economies.

Chart 3. Stabilization: Compliance with convergence criteria

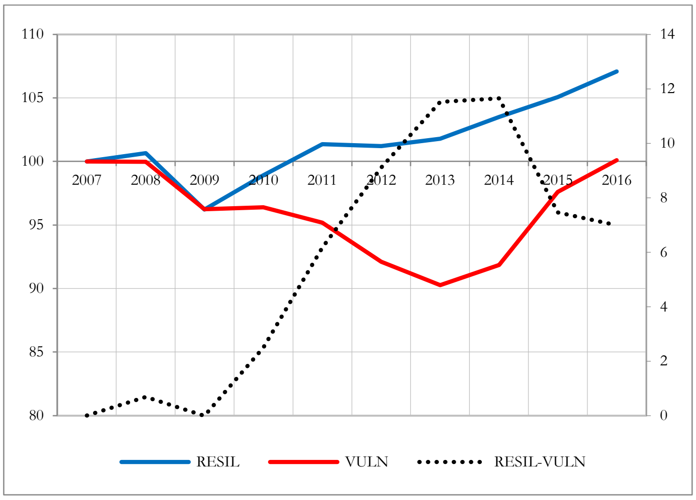


Source: Ow elaboration on Eurostat database

Countries made also use of creative accountancy, postponing and watering down adjustment and reforms, to improve their situation compared to convergence criteria. This role play proved to be inefficient, since it was time consuming, economically and socially costly, disruptive of trust and to some extent ineffective in pursuing the compliance with convergence parameters. Indeed, under the burden of the crisis and counterproductive austerity policies the financial situation worsened, particularly so the compliance of vulnerable countries (see chart 3).

The international crisis presented the bill and made clear the unsustainability of the situation. Under the pressure of events, mounting dangers and the lack of time, short term cures were enforced (austerity), which worsened performance and growth. The two groups of countries departed away (*chart 4*). It is clear that under these economic conditions reforms are difficult, but dramatically necessary.

Chart 4. The internal divergence: Cumulative gain or loss of GDP, 2007=100



Source: Own calculation from Eurostat data.

Note: RESIL-VULN on the right scale

As in the chicken game – which was made clear by finance minister of Greece Yanis Varoufakis during the first negotiations between the European Commission and Greece in 2014 and 2015 – both parties risk to lose if they yield. Fortunately, as time passed and problems grew more serious and problematic, including the political situation, the interaction moved towards a more cooperative game, as it should be in the Eurozone.

8. The present situation and the way forward

It is useful to summarize the conclusions reached so far. First, the construction of the Eurozone is insecure because it is based on an unbalanced and incomplete paradigm. Second, policy action and coordination among countries is problematic and often ineffective because there is no Eurozone economic system. The actual system is a hybrid of common and national components which often do not fit well together. Third, the Eurozone construction and working caused implicit discrimination to the disadvantage of vulnerable countries.

Fourth, Eurozone coordination and cooperation in reforms was ailing so far, while after the crisis a short term perspective and priorities took hold. Fifth, while vulnerable countries tried to free ride on the Eurozone advantages, resilient countries did not provide leadership and even less support.

The build-up of the Eurozone run the danger of creating a kind of supranational anomy. Things worked until the external and internal context were free of major tensions and there was a common will to cooperate and trust. However, the crisis and the common and national adjustment to it made clear the dangers built in such a setting. Perhaps the best evidence comes from the only really supranational achievement: the common currency and the ECB. The crisis made clear that the ECB was an incomplete central bank which was not a true lender of last resort, in particular in the case of lending to governments. This left a dangerous void in the case of liquidity crisis, serious for vulnerable countries. Simply there was no organ in the Eurozone to play roles and take initiatives and measures which are essential for a capitalist market economy. It took the strong determination and imagination of the ECB and the explicit or implicit acceptance of it by national governments to fill this void. However, this took time and costed enormous resources in terms of additional GDP loss, foregone economic performance and high unemployment.

These problems did not go unnoticed by Eurozone organs and national governments. In the last two years many projects were advanced and efforts were done to remedy, starting from the ECB bold and successful action to defend the euro. Are these efforts sufficient to lead the Eurozone to solve these problems? For some time, the main approach was muddling through: extend the flexibility existing in the treaties as much as possible, softening the stringency of convergence parameters, taking into consideration exceptional circumstances to postpone the necessary compliance with fiscal the parameters. The institutional architecture was not modified, but the budget constraint was somehow softened, or better moved to a longer time perspective and accompanied by moral suasion and peer pressure more than by administrative sanctions. As a consequence, also fiscal policies in the Eurozone started to become mildly expansionary since 2014 (EC 2016), thus supporting the strongly expansionary monetary policy implemented by the ECB since 2011.

Postponed institutional completion had to be progressively given a thought. Action was most noticeable, although not uncontested, in the monetary sector. Not only did the ECB take on the role of lender of last resort for private banks. The ECB also became a quasi-lender of last resort to governments with liquidity problems, albeit through the secondary market. Long postponed institutions and organs of full monetary unification started to be created, although the path is still unfinished. Following the single rulebook prepared by the European Commission, a Single Supervisory Mechanism (SSM) and a Single Resolution Mechanism (SRM) for banks were set up starting from 2014. These are important steps for the Banking Union which give the ECB new roles for greater transparency, lower risk and greater stability of the European banks. However, the European Deposit Insurance Scheme is still to come.

Action resumed also in the direction of creating a unified European capital market in order to overcome the persisting national character, although much is still to be done. The crisis caused the accumulation of a massive amount of non-performing loans (NPL) at commercial banks, both because of mismanagement of banks and the inability of many borrowers to honor their duties.[33] This phenomenon represent a serious concern for the solvency of many banks and, consequently, economies and governments, since commercial banks own still a significant share of public debt of their country. To deal with this problem, the proposal of establishing a European Asset Management Company for NPLs was advanced and is being discussed.

The Eurozone has a set of options to fix its problems. First, the Eurozone could activate transfers as is normal in sovereign countries and thus become a budget and fiscal union. This would be technically rather easy. However, it would require the change of treaties, which would require unanimity and politically nearly impossible. Second, the Eurozone could become institutionally complete and create full and complete common policy competences and instruments, thus becoming a political union. This would require a Eurozone government, not impossible technically, but extremely difficult politically. An important advantage of these changes is that they would transform the Eurozone paradigm and make it politically and socially more appealing and would make the system more effective.

There are also technical options, in case the political will is faltering or to support and give time for a political solution. Third, the performance of national economies should converge, thus making all countries resilient. Labor costs would decrease thanks to improved efficiency. As a consequence, business cycles would be synchronized and the common monetary policy would have symmetric consequences. This is the economically most virtuous and politically easiest solution, yet it needs deep reforms, structural change, resources and time. It is hard to believe that vulnerable countries succeed in getting all these when they have no control of their currency and fiscal policies. Fourth, differences in performance remain, but incomes diverge, thus pursuing the convergence of labor costs. Technically, this is the easiest solution and is the one pursued through austerity policies with some positive results (see chart 4), yet it is the weakest in terms of sustainable growth and social effects and tensions.

There would also be policies that, if activated, would ease the vulnerable countries' situation, giving time for the implementation of more demanding transformation. This would avoid that also Eurozone vulnerable countries go through, as Kornai (1994) showed in the case of transition countries, a prolonged transformational recession during the necessary reforms and structural change. While monetary policies were strongly expansionary as soon as 2011, fiscal policies at Eurozone level remained restrictive at least until 2013 included and eased only afterwards, which eased the situation of vulnerable countries, without damaging that of resilient countries. The same was the outcome of the depreciation of the euro that the ECB successfully pursued, particularly in 2015.

At national level, having considered the difficult circumstances of the crisis and in spite of the harshness of policies, fiscal management by vulnerable deficit countries became more reliable and predictable than earlier. However, here lies a serious problem: the adjustment was left largely, if not exclusively, to vulnerable countries. Resilient countries, in spite of their stronger financial situation and remarkable current account surplus, did not significantly contribute to ease the adjustment of vulnerable countries via expansionary domestic policies.

[33] The amount of NPLs is estimated at 7 percent of EU GDP and 5.4 percent of bank loans, but in 10 countries this latter amount exceeds 10 percent.

So far the most important missing link in the Eurozone towards recovery were investment and growth policies, respectively ailing and missing in vulnerable countries, and weak also in resilient countries due to insufficient policy determination and intercountry linkages. To be sure, the Juncker European Commission presented a European investment plan since taking office in 2014.[34] Yet this plan relied nearly exclusively on national and local resources, without a significant contribution by the EU, witnessing more the restrictive concept of Eurozone integration than the Commission's bad will. There was also a debate about keeping public resources spent for investment out of the convergence parameters, but so far no agreement was reached on this anyway technically complex matter.

9. Conclusions

Lately, during the last year, various new documents were presented and the situation looks moving ahead in a more coordinated and ambitious way than earlier. The Commission presented a White paper on the future of Europe in March 2017 (EC 2017a), which depicted five different scenarios for the future of the EU. More interesting and operational is the Road map that the Commission presented on 6 December 2017 (EC 2017b).

The Roadmap foresees important progress in three areas: financial union, economic and fiscal union, and Democratic Accountability and Governance. The core of the former is substantial progress in the banking union and capital markets union. As to the former, the Roadmap provides for the completion of the Banking Union by mid-2019, including risk reduction, European Deposit Insurance Scheme, and Single Resolution Fund. As to the latter, the agenda foresees proposing the framework for European Sovereign Bond-backed Securities for the Eurozone within 2018 and finalizing all pending legislative initiatives for the Capital Markets Union by mid-2019.

Significant progress is foreseen also in the Economic and Fiscal Union. By the end of 2018 the Commission foresees to reinforce the Structural Reform Support Programme, introduce targeted changes to the Common Provisions Regulation, and to advance proposals for the post-2020 Multiannual Financial Framework. The following six months to mid-2019 should see the adoption of the post-2020 proposals for structural reform support, dedicated convergence facility for non-euro Member States, and stabilization function.

These changes will, in the aims of the Commission, significantly strengthen the role and power of common executive organs, that should be compensated by stronger democratic

[34] The European Investment Plan, so-called Juncker plan, foresees an overall investment of €315 billion over three years (2015-2017). Of these, €21 billion is financed and guaranteed by the newly established European Fund for Strategic Investments set up by the European Union and the European Investment Bank. The rest had to be financed by public and private contributions, with a leverage of 15. The advantage of this proposal is that it adds a European push to national economies, while financing industrial and infrastructural projects. The disadvantage is that, however important, it is not sufficiently massive to really improve the situation of vulnerable countries. However, the effect was considered positive and the plan was recently refinanced and extended to 2020. See Claeys et al. (2014), Veugelers (2014). See also https://ec.europa.eu/priorities/jobs-growth-and-investment/investment-plan_en. The Commission proposed to extend the duration of the European Fund for Strategic Investments (EFSI) - the central pillar of the Investment Plan for Europe - and provide at least €500 billion by 2020 and €630 billion by 2022 (https://ec.europa.eu/priorities/sites/beta-political/files/2-years-on-investment-plan_en_2.pdf).

accountability and governance, i.e. a move towards political union. The year 2018 will be devolved to start discussing and advance legislative proposals on a European Monetary Fund, a European Minister of Economy and Finance, the External Representation of the Euro Area, the Incorporation of Fiscal Compact into EU Law, the formalization of practices between the European Parliament and the Commission. During the first half of 2019 the necessary legal framework will be adopted on each of these initiatives.

Undoubtedly this Roadmap represents a bold progress in the completion of the economic and monetary union, at least in the Commission's intention. Predictably, the debate will be around steps ahead in the completion of the Union, with important elements of political union, and checks to guarantee a fair outcome and compliance with engagement by all countries. Critical issues in this sense are the actual power and role of the European minister of economy and finance and the amount and use of the resources the minister will manage and the conditions attached to their use. Equally important will be the features and management of the European Monetary Fund and the way in which the Fiscal Compact will be incorporated into EU Law. At the same time, it is important that the Roadmap foresees also support for structural reforms in member countries.

There are strikingly dissimilar proposals on the floor presently, which would lead each to significantly different Eurozones. However, the Eurozone is still at a role play. The overall situation suggests that a compromise will be found combining support, assessment and control, with stronger determination, support and push to national reforms, hopefully also in the case of institutional reforms.

This progress, after years of muddling through, gives rise to reliable expectations. It is abundantly evident that the Eurozone setup – the Eurozone paradigm and the economic system - is not properly defined to afford and solve successfully mounting problems and that its shortcomings and weakness have cause serious costs and problems, particularly but not only to vulnerable countries. Even more worrying are the long-term consequences for people, in particular younger generations and the production system. At the same time, the fair behavior kept by all member countries in fiscal affairs contributed to rebuild trust among governments and countries. The endurance of Greece was particularly remarkable and important.

This may also give a pragmatic answer to the questions raised above, concerning the nature of the Eurozone paradigm and the critical issue of its system. The paradigm could become more balanced and complete, including both financial discipline, coordinated management of public finances and support for the real economy. As to the system, the Eurozone system is likely to remain composite, on two levels, for a long time ahead, but could become more complete and include stronger coordination devices.

Differences among European countries are too deep and deeply rooted in national history and cultures, social relations and economic structures to disappear overnight through the action of a European government. But this is not even necessary. What really matters is that the Eurozone system includes also provisions for institutional reforms and promoting growth and devices easing stronger coordination. The lack of a Eurozone government transferring considerable amounts of resources from resilient to vulnerable countries may even be an advantage against the danger of *meridionalization*[35] of vulnerable countries. This requires that the Eurozone takes seriously the need to go beyond – without abandoning - financial discipline and provide a strong push and support to rebuild ailing economies, which will anyway remain the principle responsibility of national governments.

This will likely lead to a multi-speed EU, with the Eurozone proceeding faster and more deeply than the rest of the Union. This possibility was mildly foreseen in the Rome Declaration of 25 March 2017 ("We will act together, at different paces and intensity where necessary, while moving in the same direction, as we have done in the past, in line with the Treaties and keeping the door open to those who want to join later", EU 2017). It is to be seen if will concern also the Eurozone.

An signal of a potential multi-speed Eurozone is the treaty between France and Germany that the parliaments of the two Eurozone countries will contemporarily approve on 22 January 2018 in the form of a common declaration.[36] The prelude to a stronger cooperation between the two countries was an important article co-authored by the presidents of the French and German central banks published in January 2016, in which the fundamental alternatives for the Eurozone were outlined and the necessity of combining fiscal discipline with more integration was clearly expressed (Villeroy de Galhau, François and Jens Weidmann (2016). The French-German treaty, which comes after 55 years from the original Élysée Treaty 22 January 1963, foresees enhancing bilateral cooperation in a number of important fields within European integration. The new treaty undoubtedly intends to strengthen bilateral cooperation as the revived "engine" or European integration, but could also work as the advanced core of a multi-speed, or perhaps better a multi-role Eurozone.

If the present drive continues and is effective, the paradigm and system issues would find a different solution in time. The present revival of the Eurozone economy provides an opportunity that should not be wasted. The Eurozone system would become more balanced and complete, including components that are presently uncovered or part of national paradigms. Similarly, the Eurozone system would increase its domain and get a stronger role, both direct and in the coordination of national systems. Clearly, the Eurozone will remain quite different from fully sovereign national countries, yet more complete and effective. The common interest of countries which chose freely to enter irreversibly the Eurozone should be a sufficiently strong incentive to pursue a construction that works effectively and efficiently.

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[35] Refers to the segmentation of national economies, such as between the North and the South ("Meridione") of Italy, or the West and the East of Germany.

[36] See Michele Pignatelli, 'Trattato dell'Eliseo, Berlino e Parigi pronte a consolidare i rapporti', *Il Sole 24 Ore*, 5 January 2018. Apparently the common declaration aims at creating a common French-German area based on harmonized rules, particularly in company law, bankruptcy procedures and the tax system for companies. Other provisions include uniform social norms with similar rights, stronger bilateral cooperation in education and vocational training, single energy market, stronger cooperation in defense, immigration, and environmental issues. To be sure, other initiatives are taking place also with other countries.

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