THE EUROZONE EXPERIENCE: MONETARY INTEGRATION IN THE ABSENCE OF A EUROPEAN GOVERNMENT

edited by
Franco Praussello

FrancoAngeli

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CONTENTS

INTRODUCTION

How Eurozone Member Countries Did Not Succeed in Fixing the Sovereign Debt Crisis
Franco Praussello 9

SECTION ONE
A HOLISTIC VIEW ON THE EUROZONE EXPERIENCE

Fighting the Wrong Enemy
Paul De Grauwe 27

Addendum: How to Embed the Eurozone in a Political Union 34

Towards the 20th Anniversary Party of the Eurozone: Will It Be Sumptuous or Meagre?
Miroslav N. Jovanović 36
1. Introduction 36
2. Background 37
3. Deficits and debt 41
4. Deficits: conflicting policy advices 46
5. Expanding or breaking up the eurozone 47
6. The eurozone crisis and its “resolution” 49
6.1. Greece 49
6.2. Ireland 54
7. Steps ahead 57
8. Conclusions 62

SECTION TWO
LESSONS OF EMU FOR MONETARY INTEGRATION

Asymmetric Shocks Within the Eurozone
Franco Praussello 71
1. Introduction 71
2. Early economic criticism of EMU 72
3. The EMU breakup hypothesis 77
4. Asymmetric shocks of federal and national origin 82
5. Asymmetric shocks of national origin in Germany 87
6. Final remarks 91

Endogeneity of Optimum Currency Area Features for Interpreting the Eurozone Setup
Franco Praussello 97
1. Introduction 97
2. A key theoretical innovation 98
3. Where the new paradigm comes from 99
4. An old controversy over the endogenous consequences of monetary union 101
5. Monetary integration and trade 102
6. New developments 103
7. Inadequacies and doubts in the case of EMU 106
8. Closing remarks 109

The Slowdown of Exports in the Euro Area: Some Evidence from Statistical Tests of Structural Change
Andrea Marino 114
1. Introduction 114
2. Testing for structural change: results from the test of Zivot and Andrews (1992) 121
3. Testing for structural change: results from a Generalised Logistic (GL) model 124
4. Testing for structural change: results from a CUSUM test 127
5. Some tentative explanations of test results 129
6. Summary and conclusions 132

Evaluating the Eurozone Membership for Italy
Franco Praussello 137
1. Introduction 137
2. The EMS: the crawling peg period 138
3. The EMS: the convergence game 140

4. From the Werner Plan to EMU 143
5. Costs and benefits in the short run 146
6. Costs and benefits in the longer term 148
7. Could Italy abandon the eurozone? 153
8. Closing considerations 154

The First Ten Years Since the Adoption of EMU: an *Ex-post* Assessment on the Process of Convergence of Southern and Central-Northern Italy
Mario Centorrino and *Ferdinando Ofria* 159
1. Introduction 159
2. *Ex-ante* forecasts on the impact of the single currency in the South 160
3. The single currency: a balance sheet for the economy of the South after around a decade 164
4. Conclusions 168

SECTION THREE
GOVERNMENT REACTIONS TO THE SOVEREIGN DEBT CRISIS

Strengthening the Economic Governance of the Euro Area
Nikolaos Baltas 179
1. Introduction 179
2. A new European economic convergence 180
3. Concluding remarks 183

The New European Governance: the European Semester and the Coordination of Economic and Budgetary Policy
Gaetana Trupiano 187
1. Introduction 187
2. The reasons for the European Semester 188
3. The decision to institute a new procedure 188
4. How the new governance procedure works 192
5. Final remarks 194

Greek Winds and American Blowers
Antonio Mosconi 197

SECTION FOUR
TOWARDS A EUROPEAN FEDERAL GOVERNMENT

Towards a European Federal Fiscal Union
Alberto Majocchi 207

1. From the financial to the sovereign debt crisis 207
2. The recovery plan and the creation of a Federal Fiscal Union 215
3. Concluding remarks 221

European Recovery Plan, Union Bonds and Budget Reform
Alfonso Iozzo and *Alberto Majocchi* 224

No to a Phoney Fiscal Union, Yes to a Federal Government
Guido Montani 231

A World Currency for a World New Deal
Antonio Mosconi 235
1. The rise and fall of the Dollar 235
2. *Dollar standard*, fundamental imbalances and the crisis of the American hegemony 241
3. Globalisation, de-Dollarisation and creation of Regional Currency Areas 246
4. The cooperative solution 251

ANNEX
COMMISSION WORK PROGRAMME 2012

Delivering European Renewal
Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions
European Commission 263
1. Introduction 263
2. Building a Europe of stability and responsibility 265
   2.1. Financial sector reform: investing in confidence 266
   2.2. Financing the future: securing sustainable public revenue 267
3. Building a Union of sustainable growth and solidarity 268
   3.1. A Single Market for growth 268
   3.2. Empowering people in inclusive societies 270
   3.3. Paving a path to a sustainable future 271
   3.4. An open Europe for citizens 272
4. Giving the EU an effective voice in the wider world 273
5. Smart regulation and effective implementation 275
   5.1. Smarter spending together 275
   5.2. Smart regulation 275
6. Conclusion 276

INTRODUCTION

HOW EUROZONE MEMBER COUNTRIES DID NOT SUCCEED IN FIXING THE SOVEREIGN DEBT CRISIS

Franco Praussello

By late 2009, the crisis chain started with the subprime bubble bursting in the US two years earlier spread to the eurozone member country public sector, which had been fragilised by the massive government bail-out finance usually mobilised in order to contrast the global financial and economic predicament of 2008-2009. Public debts deemed to have reached unsustainable levels, in the presence of poorly managed and scarcely competitive economies, pushed international markets to price possible defaults in eurozone peripheral countries, jeopardising the stability of the euro area as a whole.

Confronted with the sovereign debt crisis, the fault-lines along which the eurozone had been devised and built up came to the fore. Lacking essential features to be considered an optimum currency area – as a number of scholars had famously anticipated[1] –, the unsatisfactory cohesion among member countries risked jeopardising the survival of the Economic and Monetary Union (EMU), or euro area[2], just a couple of years after its tenth anniversary, which was greeted by a paean of optimistic judgments about its working and successes[3].

Instead of mending the eurozone governance in view of its ultimate viability, the reaction of member countries merely consisted in setting up a number of financial supports aimed at helping peripheral governments face difficulties, linking the European aid to heavy conditionality, in order to avoid future moral hazard issues. In such a way, the provisional European

[1] See in particular (De Grauwe, 2006*a*).
[2] In technical terms, a proxy of the eurozone low degree of cohesion can be found in the miserable size of the EU centralised budget, with a weight of about 1% of the Union's GDP, and hence unable to exert significant stabilisation effects in the face of asymmetric shocks.
[3] See for instance European Commission (2008).

Financial Stability Facility (EFSF) and its successor, the European Stability Mechanism (ESM), were established and aid packages for Greece, Ireland and Portugal were approved in the period 2010-early 2011. Later on, by mid-2011 contagion effects of the sovereign debt crisis extended to Italy and Spain, showing that the debt predicament did have a systemic origin. Moreover, in 2012, at the eve of a second Greek aid programme, the treaty for a European fiscal compact was signed introducing severe limitations in the management of the fiscal policy of eurozone member countries, even though not all economies caught in the debt trap were responsible of fiscal misbehaviour.

In general terms, faced with the sovereign debt crisis, the eurozone member countries had three basic options: *i)* the continuation of the current impasse, in which time and again the States are providing guarantees that after a few months markets will end up judging inadequate; *ii)* the failure of monetary integration in its existing form, by the withdrawal of a divergent country or the breakup of the entire system; *iii)* and finally the evolution of the euro area in the direction of a banking, fiscal and budgetary union, alongside the corollary of the emergence of some form of European government[4]. With the caveat that while the first option seems scarcely sufficient to give rise to stable solutions – at any rate in the medium run –, the other two would solve the root causes of the debt and the eurozone crises: in the first case by the end of the experience of monetary integration, at least in its present connotations, and in the second one by steps towards political union, guarantee par excellence of the monetary union stability. Adding a further specification that all three options involve difficulties and costs that are far from negligible.

Let us now examine the contents of the different options, starting with the continuation of the *status quo*. In spring 2010, when the first signs of sovereign debt crisis in Greece emerged with the explosion of spreads relative to government bonds issued by Germany[5], eurozone countries realised that monetary integration did not ensure a reduction in structural differences between the economies of member countries. In the absence of a common

[4] Many authors deem the *status quo* situation untenable and limit the scenarios out of the crisis to the extremes of the breakup on the one hand, or completion of the economic and fiscal union on the other. Among them, see the recent work of Bergsten and Kierkegaard (2012), according to whom, once the structure of the eurozone is completed – now only half-built –, Europe will emerge stronger from the crisis.

[5] De Grauwe and Ji (2012) show that the behaviour of peripheral eurozone country spreads is not related to the increase in the debt-to-GDP ratio, being the result of waves of market valuations (market sentiments), alternately too negative or positive. On the narrative of subsequent country crises in Greece, Ireland, Spain and Italy see Jovanović (2012).

economic policy and in the presence of a failure of the Stability and Growth Pact (SGP), with provisions aimed at curbing expansionary fiscal policies first violated by core countries such as Germany and France, structural differences had increased rather than diminished. Thus, one of the shortcomings of foundations of the monetary union became apparent, which lacked common tools of governance, beyond the single monetary policy entrusted to the European Central Bank (ECB), as well as several mechanisms of shock absorption described by the optimum currency area theory.

The design of the French and German governments also lacked clarity as regards the treatment of the country of origin of the crisis, given that at first they seemed to point to a bail-out of Greece pure and simple, while Germany soon after insisted to involve private creditors (Private Sector Involvement, or PSI), and primarily banks, to share the cost of a debt restructuring voluntarily accepting a haircut. PSI represented one of the biggest mistakes in the whole affair that undermined the confidence of the markets, making clear that a eurozone sovereign debt was no longer a safe asset (De Grauwe, 2010)[6]. Later on, on the occasion of the Special Summit of December 2011, markets were informed that the Greek case had to be considered very special and unique, giving up any future claim to involve private creditors in losses of possible restructurings. Finally, in March 2012 the voluntary restructuring of the debt turned into an orderly technical default of Greece, with a total haircut for creditors exceeding 70% of the initial capital.

All these uncertainties had the effect of raising the cost of saving Greece beyond measure, the burden of which was at the start entirely bearable due to the low debt size of that country with respect to the eurozone GDP, and also to spread contagion not only to other peripheral countries such as Ireland and Portugal, but also, more recently, to Italy, Spain, and finally to France and Germany themselves, amplifying the crisis in the whole euro area, which was in danger of not being able to survive. Not to mention that the funding required for meeting the needs of potential bail-outs seems to be becoming increasingly important and that solutions of an emergency, such as unlimited monetary interventions by the ECB, might collide against the letter and the spirit of the Treaty of Maastricht. In the former case owing to the explicit ban to the central bank to directly fund government

[6] Since the Deauville Agreement between France and Germany in October 2010 on the PSI, or the need to involve creditors in the cost of Greek bail-out, by imposing upon them a loss (haircut) of 21% initially and then of more than 50%, markets received the calamitous message that sovereign bonds issued by euro area countries could no longer be considered as risk free. See also Orphanides (2012).

expenses and in the latter one for prompting eurozone banks to use the Long Term Refinancing Operations (LTROs) recently launched by the ECB with an amount exceeding one trillion euros over three years for investing in secondary market government bond purchases[7].

Finally, regarding the fate of Greece, it must be said that to date it remains unclear if, after the restructuring of the debt and its technical default, the country – at least in the intentions of the Franco-German axis – will be allowed to remain in the eurozone or will be obliged to abandon it.

Concerning costs associated with the option of continuing the *status quo*, we note that in addition to direct costs arising from financing mobilised by the EFSF and the ESM[8], indirect losses should also be considered due to restructuring of debt (from more than 50% of the nominal values in the case of Greece to 20-25%[9] of the possible restructuring of Italian public debt) and the subsequent failure or rescue of creditor banks and holders of sovereign securities, together with those resulting from contagion transmitted to countries of the area as a whole, by the loss of credibility of the eurozone and the contractionary effects induced on the main poles of the world economy. With the caveat that the costs described above may be partly mitigated by the depreciation of the currency caused by the difficulties of the eurozone, with a positive income effect linked to a rise in European exports.

In any case, another cost to take into account concerns the loss of income and employment due to measures of fiscal consolidation repeatedly undertaken, with which countries facing a debt crisis are trying to reassure markets, often without success, following the deflationary recipes imposed by the ECB, Germany and the International Monetary Fund (IMF). However, this is a rather controversial issue, in relation to which you face two possibly opposite interpretations: on the one hand Fisher's seminal analysis (1933) going back to the 1930s on contractionary effects of public spending retrenchment, rendering often impossible to achieve budget

[7] Purchases of stressed eurozone government bonds in the secondary markets and LTROs by the ECB have both raised widespread criticism in Germany and in the ECB governing council. Moreover, LTROs credit might have produced a moral hazard risk worse than if ECB had directly bought bonds. See Atkins (2012) and De Grauwe (2012).

[8] The current firewall against possible new sovereign debt crises has been expanded to no more than 500 billion euros in March 2012, that is, to a level which could be insufficient to bail-out Spain or Italy, should the necessity arise (Münchau, 2012).

[9] In the case of the recent Greek debt restructuring and the following technical default in March 2012, taking into account the longer maturities and the lessened interest rates attached to the swapped new bonds, losses for creditors exceeded 70%.

surpluses to be allocated to the debt reduction, and on the other the more recent theory of non-Keynesian effects of fiscal consolidation, which would cause growth to resume in the medium run (Giavazzi *et al.*, 1999). Yet, in the presence of severe falls in aggregate demand and deflationary forces at work in today's European economies and in other major countries around the world, the theory of expansionary fiscal retrenchment seems inapt to be applied to the case of the eurozone.

The conclusion to be drawn from an examination of contents of this first option out of the crisis is that in reality the *status quo* scenario is quite unstable, since at best it could lead to subsequent debt restructurings by other divergent countries, such as for instance Portugal or even Spain and Italy, with costs difficult to assess, and at worst could result in a more or less extensive collapse of European monetary integration with deflationary shocks transmitted to the entire world economy.

The inability thus far demonstrated by euro area countries and the Franco-German leadership to address the sovereign debt crisis in Europe, with significant new steps towards the completion of the economic union through the creation of a banking, fiscal and budgetary union and some form of European government, could actually be the prelude to a breakup of the eurozone or its total collapse. In this way, the breakup of the eurozone (that literature had initially considered as a pure conjecture with the works of De Grauwe [2006*a*, 2009] and Eichengreen [2007] brought in support, respectively, of a high or a small likelihood that European monetary integration might fail[10]), would cease to be a theoretical case study becoming subject to assessments and strategies for economic policy.

This second option out of the crisis in a regressive way, perhaps dealing a deadly blow to the European integration process as a whole, could give life to some alternative outcomes, depending on the assumptions made.

A first hypothesis might be the secession from the single currency of one or more peripheral countries, starting with Greece. By definition, a divergent economy within the monetary union, weighed down by a current account deficit associated with a loss of competitiveness and a public debt at high risk of insolvency, cannot resort to the usual tools available to a country under conditions of monetary autonomy. On the one hand, it cannot use the currency devaluation or depreciation to adjust the current account and, on the other, it is not able to reduce the real burden of the debt stock by monetising it with an appropriate dose of inflation. Lacking its

[10] On this point see also Praussello (2011).

own currency and being indebted in a currency over which it has no direct control[11] – as once happened to developing countries –, the only adjustment tool at its disposal is the so-called "internal devaluation", that is, a gradual reduction in domestic costs, mainly through a compression in labour costs in relative terms. In the absence of resource transfers by a central authority, for a diverging country this effectively means having to face a long period of deflation with high economic, social, and even political costs[12].

Confronted with such a prospect, the temptation to return to the national monetary autonomy may exceed the tipping point of secession, especially if some government forces had decided to exploit the Eurosceptic and populist reaction against the austerity programmes imposed by Europe and particularly by Germany. However, this road would be fraught with obstacles and might entail high costs. In the first place it should tackle the thorny legal abandonment of the eurozone.

As it is well known, treaties do not foresee the withdrawal of a single country, nor expulsion from the eurozone, just to avoid speculative attacks on euro. However, the Lisbon Treaty allows for secession from the EU following a special procedure, and this could provide a tool to regain monetary sovereignty, formally abandoned forever with the accession to the eurozone. Yet, it is debatable whether a country not being able to withstand the constraints of monetary union might be willing to add to the enormous costs caused by voluntary abandonment, identified in detail by Eichengreen (2007), also those related to the waiver of benefits of EU membership as such, starting with the free access of goods, services, labour and capital to the European internal market. Conversely, if the country decided to secede with *ad hoc* legal formulas to be established among partner countries, leaving only

[11] This goes well beyond the fact that monetary policy is currently allocated to central banks independent from governments. Indeed, a central bank, though independent, may decide to contribute to the monetisation of debt, as it does now the UK, which is recording a progressive depreciation in pound sterling and a corresponding increase in inflation to levels higher than the eurozone's. In this respect, the controversy recently fuelled by some French authorities about the different treatment that rating agencies had given to France, with the loss of the AAA grade, compared to that paid to the UK, which in some respects presented a worse economic situation, was baseless. The UK, unlike France, has an independent currency and a central bank of its own, and this is sufficient, other things being equal, to reduce the riskiness of its bonds.

[12] According to two recent pieces of research provided by Goldman Sachs, adjustment within the eurozone would require divergent member countries to achieve the following: for Portugal, Greece, Spain and Italy a virtual real depreciation of exchange rate, respectively, of 35, 30, 20, 10-15%, *i.e.* an internal devaluation taking 15 years for Portugal and Greece, 10 years for Spain and 5 to 10 years for Italy (Wolf, 2012).

the monetary union but wanting to remain an integral part of the EU, it is possible that the latter reacts by reducing or abolishing resource transfers in its favour through the channels of structural policies, and even submitting to customs duties its exports to the single market.

Indeed, and this is the second point to consider, the reintroduction of the national currency – say the drachma – would be followed by a sharp depreciation, which would make Greek exports less expensive, endangering, however, the stability of the internal market, where products originating from other eurozone countries would see their market shares shrink. At the same time, domestic inflation rates would tend to explode, with effects possibly multiplied compared to the depreciation of the new drachma against the euro.

Finally, the fact that the part of the Greek debt held by residents of other countries would continue to be denominated in the single currency[13] would make the burden of repayment unsustainable, causing the failure of the Greek Treasury and, along the credit chain, of banks and foreign holders, which would require new bail-outs at taxpayer expense, at least to avoid the blocking of credit circuits in creditor countries. All this, in the presence of bank runs, capital flights, border controls, social and political crises and deep shock waves that would involve other peripheral countries of the eurozone, jeopardising the stability of the single currency, whose credibility would be severely shaken, and eventually having adverse effects on the entire European and world economy. For Greece, within the EU, the loss of bargaining power and sovereignty will be worse than that experienced at present and, internationally, an exclusion from financial markets would follow, which would last long. In summary, this hypothesis, which could obviously be applied also to the case of other economies such as Italy, would result in higher costs for all countries involved and could end with the collapse of monetary integration.

Another hypothesis concerning exit from the crisis by the disintegration of the euro area could relate not so much to the secession of one or more peripheral economies that are particularly vulnerable but by its very leader country. Germany, confronted with what it is considering as repeated violations of the spirit of the Maastricht Treaty, may decide to withdraw from the single currency, regaining full sovereignty, and reviving the Deutsche

[13] Or possibly, the part of it denominated in euro but issued under foreign laws.

Mark[14]. Since the sovereign debt crisis in Europe has started, repeated attempts to counter it with interventions by the ECB, in particular through purchases of government debt on secondary markets and LTROs, have been made by overcoming the opposition of the central bankers of German origin. This had initially led to the resignation of Axel Weber, President of the Bundesbank, and then by Jürgen Stark, a member of the ECB executive board. Even proposals, advanced by many[15], to make the ECB a lender of last resort[16] entitled to purchase unlimited amounts of government debt securities, are deemed inadmissible by German authorities[17] and the generality of professional economists, because contrary to some of the cornerstones of the Maastricht Treaty: the prohibition of government financing from the ECB, together with the sole responsibility of each country for its public debt ("no-bail-out clause"), and finally the almost absolute obligation of the ECB to limit its mission to maintain price stability.

In this context, we can understand why an abandonment of the euro by Germany represents in any case a state of the world to be seriously taken into consideration.

However, among all the possibilities considered, this would very likely prove to be the most explosive outcome from the political point of view, and probably even in historical terms. If such were the case, in fact, the basis of power would be destroyed which has held up the whole process of European integration over the past sixty years: the Franco-German entente, and Germany itself would see strengthened the suspicion of what was called the German euro nationalism (Beck, 2011), a new version of the traditional hegemonic drive by the most powerful nation State in Europe.

[14] During the 2011 acme of the sovereign debt crisis, rumours multiplied about the preparations of Germany and other countries to print and subsequently introduce into economic circuits old national currencies in the new version following a possible eurozone breakup. These are, by definition, uncontrollable items that do not deserve to be taken into account. However, they may have had some influence, if it is true that markets are sometimes so in a panic and slave to irrationality as to make outrageous mistakes, which happened in the summer of 2011, when a series of political fiction stories about the revival of the Deutsche Mark by Germany, published by *Le Monde* in its traditional summer recreation pages, was taken seriously for some time, sparking speculative attacks against French government securities.

[15] See, among others, De Grauwe (2011) together with Alesina and Giavazzi (2011).

[16] Indeed, as it has been clarified by the President of the ECB Draghi (TMNews, 2011), the Institute of Frankfurt is already lender of last resort, but only to eurozone solvent banks.

[17] One often neglected constraint is that the German government, in negotiations relating to the protection of the euro area, is strongly affected by a number of decisions of the German Constitutional Court, on the need for the content of individual agreements to meet approval of the Berlin Parliament.

Then, the evil prophecy of Feldstein (1997) might materialise, who in some texts written on the eve of the launch of the euro forecast, following the failure of the single currency, the end of the integration process and the resumption of conflicts between France and Germany, calling into question the most important result provided by the historical process of European integration, that is, the maintenance of peace in Europe.

Such considerations, however, should also be sufficient to convince us that this catastrophic assumption is unlikely to be realised.

Yet, from the economic standpoint, if it were to leave the eurozone, Germany would be greatly penalised: as a result of the sharp appreciation of the new Deutsche Mark against the single currency, its exports would undergo substantial reductions, with negative effects on growth rates and employment levels[18]. There is also little doubt that monetary integration could not withstand the shock generated by the secession of Germany. The collapse of the entire structure of the eurozone would defeat the long efforts deployed by Germany after the start of European integration to secure a stable export market in Europe for its industrial products, away from competitive devaluations of other countries. With the caveat that the effects caused by the breakup of the euro would lead to further damage to it, following the default of peripheral countries, with negative consequences in terms of loss of income and increases in unemployment across Europe and around the world.

Under the disintegration scenario of the euro area, a third hypothesis, then, may lie in its replacement with two separate monetary zones. The euro area virtuous North countries, gathered around Germany, would be faced by the financially unreliable eurozone countries in the South, while a flexible exchange rate system would link the two currencies, called by some "neuro" and "sudo", respectively (Taylor, 2010). The outcome of this hypothesis depends mainly on the fact that in the area of the neuro France is also included. For Italy, probably, its fate would be sealed: the traditional mistrust of Germany towards the financial irresponsibility of the Rome government would in all likelihood relegate it to the group of the "Club Med" countries.

Concerning France, if she could stay in the North, the Franco-German axis, understood as the power base necessary for the continuation of the integration process, would be safeguarded, reducing the cost of dismantling the single currency.

[18] The share of German exports to the eurozone in 2010 was 41% of total sales abroad, and was down compared to 1999, when it amounted to 45%. However, during the same time period the value of German exports to the single currency area rose from 230 to 400 billion euros (Straubhaar, 2011).

In economic terms, this solution would also involve lower costs than previously assumed, given that the immediate appreciation of the neuro and the corresponding depreciation of the sudo would act as instruments of imbalances adjustment between core countries and peripheral economies, which could possibly prevent their default, even though their foreign debt would continue to be denominated in the old single currency. However, the integration situation would devolve to that which characterised the mid-1980s, when the European Monetary System (EMS) was in a phase of relative stability, now totally lacking. In addition, the goals of full economic integration and the creation of a European government will turn away indefinitely in time, while the maintenance of some form of monetary cooperation in Europe would probably not generate the heavy contagion effects of a disorderly collapse of the eurozone.

Finally, we examine the third of the possible options regarding the ways out of the sovereign debt and the euro area crises: the progressive solution of increasing integration, until reaching the completion of economic unification, that is, a fiscal and a budgetary union, managed by some form of European government, which has the power, as underlined by De Grauwe (2006*b*), to tax and decide expenses for the eurozone as a whole. In political terms, it is an option difficult to implement[19]; however, it may be winning as the only solution that can be effective, if it is true that historically the integration process has recorded the most significant advances in its own in times of crisis and difficulties.

At the December 2011 Summit the EU countries, except for Great Britain, have decided to take a road to institutional reform, which could lead to these ambitious goals[20]. The specific contents of these reforms were discussed in early 2012, and subsequently written down in the Treaty on fiscal compact signed in the spring of that year[21]. Pending its ratification by a majority of its

[19] To overcome political difficulties, Pisani-Ferry (2012) suggests advances along the path of fiscal union and the issuance of Eurobonds through experimental schemes of limited scope. Other developments in the intermediate direction of the fiscal and budgetary union could cover the birth of a European Monetary Fund (EMF), endowed with vast resources and tasks similar to those performed by the IMF (Mayer and Gros, 2010).

[20] Moreover, after the approval at the March 2011 Summit of the "Euro Plus Pact", aimed at improving the economic governance and financial stability of the eurozone, at the end of that year a plan for strengthening the EU's SGP entered the implementation phase with the launch of a new set of measures called "Six Pack", including five regulations and one directive proposed by the European Commission.

[21] The Treaty was signed by all but two EU member countries (the UK and the Czech Republic).

proponents, with the abandonment of the unanimity rule (which anyway marks significant progress), the new treaty shows a number of limitations, from the standpoints both of institutional approach and its dispositions. As to the latter, in its initial phase the treaty would provide more stringent requirements than the Maastricht constraints on finance of individual countries, starting from inclusion in the Constitution of the principle of a balanced budget, complemented by a commitment to progressively reduce the stock of public debt exceeding 60% of GDP, in addition to the binding European control over the budgets of different countries. For now, there is no trace of the possibility of issuing Eurobonds with the common guarantee of eurozone countries[22], nor the establishment of a European Ministry of Finance and, in general, of an increase in size of the Community budget and the launch of European measures for fostering growth. These are significant limitations in two respects. First, because the imposition of austerity policies in the absence of plans for more growth is likely to reinforce the deflationary pressures already present in the European economy, making it more difficult to achieve financial stability. And second, because the failure to strengthen the Community budget, still anchored to 1% of EU GDP, would continue to render irrelevant its stabilisation effects for the benefit of countries affected by falls in income and employment, in contrast to the objective of setting up a fiscal and budgetary European union.

Concerning the procedures, all this is cast in an inappropriate institutional framework different from that of the Community method, since it is based on the inadequate instrument of intergovernmental cooperation, which will not mend the critical democratic deficit nor its poor or no efficacy.

However, despite these glaring shortcomings, it is possible that after the launch of the new Treaty on fiscal compact the euro area is able to remove its initial defects taking steps towards the aims of strengthening the eurozone setup by developments towards a fiscal and budgetary union and the emergence of forms of European government.

Such an agenda could be based on two basic and equally significant ingredients: in the first instance a Union-wide growth plan, which is needed in order to offset the self-defeating excessive austerity measures imposed on peripheral countries with the goal of reducing fiscal misalignments,

[22] However, leaders of major parties in the European Parliament have presented an amendment to the Treaty on fiscal discipline, with a view to set up a road map aimed at creating “the institutional, economic and political conditions” to enable the member countries of the euro area to issue “part of their sovereign debt in common, with joint and several liabilities” (Spiegel, 2011).