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Market and Government: Past and Future for a Democratic Emu Fostering Growth and Not Prone to Financial Crises

Acocella N*

Dept of Methods and Models for Economics, Territory and Finance, Sapienza University of Rome, Rome – Italy

***Corresponding author:** Acocella N, Dept of Methods and Models for Economics, Territory and Finance, Sapienza University of Rome, Rome, Italy; E-mail: nicola.acocella@uniroma1.it

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Abstract

The design of the Union stood on theoretical foundations predicating for a wide role of markets and policy rules. It has proved to be conducive to divergence of the countries' strategies of growth as well as financial speculation, crisis and deflation. The Maastricht regime was indeed built in a way to foster instability itself, as it featured powerful built-in destabilizers nourishing divergences and fragility. The paper deals first with the structure of EMU institutions, the asymmetries existing in the Union and the imbalances that descended from the institutional set-up. It also investigates the theoretical inspiration and the practical interests underlying this set-up. The theoretical progress intervened in the last couple of decades and the need for new goals and a new contract are also sketched. A solution to the democratic deficit would require not only a change in the orientation and the modes of current decisions, but also and mainly a radical change in the institutional setting of the EMU starting from a process of re-envisioning the goals of the EU. A democratic state must respect the will of its citizens, but also be efficient. From this point of view, a number of reforms of the Euro Area are in order.

Keywords: EMU; Institutions; Asymmetries; Imbalances; Democracy

JEL Classification Code: F45; F55; H62; H63; H77

Introduction

The design of the Union stood on theoretical foundations predicating for a wide role of markets and policy rules. It has proved to be conducive to divergence of the countries' strategies of growth as well as financial speculation, crisis and deflation. The Maastricht regime was indeed built in a way to foster instability itself, as it featured – and still does so - powerful built-in destabilizers nourishing divergences and fragility. The paper deals first with the structure of EMU institutions, the asymmetries existing in the Union and the imbalances that descended from the institutional set-up. It also investigates both on the theoretical foundations on which it stood, predicating for a wide role of markets and policy rules, and the practical interests underlying this set-up. The theoretical progress intervened in the last couple of decades and the need for a new goals and a new contract are also sketched. After designing the desirable goals of a new EMU, we indicate the need for a more democratic Union and a possible articulation of the new common institutions. A solution to the democratic deficit would require not only a change in the orientation and the modes of current decisions, but also and mainly a radical change in the institutional setting of the EMU. This would be difficult to implement in the absence of a process of re-envisioning the goals of the EU and its socio-economic policies. The paper is organized as follow. In the next section, we deal with the structure of EMU institutions, the asymmetries existing in the Union and the imbalances that descended from the institutional set-up. Section 3 investigates the theoretical inspirations and the practical interests underlying this set-up. In Section 4 the theoretical progress that have emerged in the last couple of decades and the need for new goals and a new contract are sketched. Section 5 designs the desirable goals of a new EMU. Section 6 concludes

by indicating the need for a more democratic Union, which can be obtained by tending to overcome country and sectional interests, the influence of the different sizes of countries and the asymmetry of power between 'creditor' and 'debtor' countries as well as to increase the power of citizens against that of markets and unelected institutions.

The Institutional Structure and the Divergences Deriving from It

This section presents the EA institutions, synthetically in the first sub-section and the nature of existing asymmetries in sub-section 2.2. The resulting imbalances are discussed in the final sub-section.

The institutions

As is well known, the European Monetary Union (EMU) is a currency union. As such it has a common currency. Monetary policy is decided by the European Central Bank (ECB). Until recently, European institutions have been characterized by the existence of only one common public institution, the ECB, and absence or weakness, of other common institutions in fields such as financial regulation, regional and industrial policy, wage policy, fiscal policy. Markets and the single currency played the dominant role. In fact, the basic rule that the Union relied on was that of the markets. Their working was intended as to offer the basic mechanism for regulating economic activity within the Union. Other rules aimed at constraining the action of both the only common public institution and the countries' governments. The former consisted in the choice of a model of independent and conservative central bank. The latter were expressed by the Stability and Growth Pact (SGP). This was dictated by many considerations, and possibly by the implicit view in the Treaty (inherited from the Delors Report) that 'the constraints imposed by market forces might either be too slow and weak or too sudden and disruptive'.

These rules, together with markets, seemed to be central to the EMU construction. They derived from:

- The conviction of the possibility of markets to solve problems, on the one hand, and
- The need for constraining the action of public agents at the country level by conservative fiscal policy, while ensuring a unique and conservative monetary policy to act as a further constraint on countries, on the other.

The asymmetries

The situation in Europe after adoption of the euro was marked by the pre-existing imbalances that had not been eliminated in the process preceding admission to the third stage of the monetary union. Contrary to the previous opinions, the structural and behavioural changes that were expected as a consequence of implementing the Union's institutional design and should eliminate the residual differences between the various countries did not take place or were only partial, at least in some countries, i.e. in peripheral countries. Neither the action of agents of change nor formal and informal institutions acted, at least in a way to avoid the formation or permanence of large imbalances. In the EA over the period 1960-2017 there has been no synchronization of economic and financial variables as well as of their underlying macroeconomic fundamentals in business cycles. The monetary union has even further increased macroeconomic divergences. Our analysis will try to explain the role played by the EA monetary institutions and policies. The asymmetries, which in some cases became stronger in the early 2000s, consisted in inefficiencies in the private and public sector, especially of higher inflation countries, and with the microeconomic policies of lower-inflation countries. In fact, facing the inefficiencies and high costs of peripheral countries, Germany cut its wages both before and after the establishment of the EMU. The monetary union has not got rid of the asymmetries and has possibly even enlarged them. Neither the action of agents nor formal and informal institutions have acted, at least in a way to avoid the formation or permanence of large macroeconomic imbalances. Our analysis will try to explain the role played by the Euro Area institutions and policies.

The macroeconomics of imbalances and mistakes in constraining a part of them alone

National accounts establish some fundamental identities that must be taken into account for understanding the relevant issues and implementing appropriate solutions. For any open economy an identity links the private financing imbalance to the external and the government's fiscal imbalances. It shows how external imbalances, even in the absence of fiscal irresponsibility, can lead to accumulating public debt, capital outflows, and a financial sector liquidity crisis in which private debt must be replaced by public debt. Fiscal irresponsibility, as in the case of Greece, simply adds to this underlying imbalance. In fact, excess of investment over private savings can be associated to either a government budget deficit or a current-account deficits or both. Thus, attention has to be given to all, and the factors that each one depends upon, because if one goes further out of balance then the others will go further out of balance too. One imbalance can easily turn into another imbalance and the causality can, and does, flow either way. Then, there are three potential imbalances to control in a static context, and thus policymakers need three independent policies. Financial regulation can address private-financing imbalances; fiscal controls can ensure public accounts balances; structural measures (and when possible, monetary or currency policy) should ensure

competitiveness and current account balances. However, all three policies must be carefully coordinated together, since each policy, while being mainly directed to one target, has also an influence on the others. In presence of macroeconomic imbalances as basic as these, in fact, it is no longer feasible or sensible to pretend that they do not interact or materially affect each other—as much of the literature has tended to do in the past. Change in each one of them has the capacity to undo the balances to which it has not been assigned and thereby destroy the impact of other policies on the balances assigned to them. One of the lessons of the recent financial crisis is that the only way out is to use coordinated (jointly determined) packages of policies rather than to design separate fiscal, monetary, and regulation policies for each given situation. The picture is complicated in a monetary union, since deep economic and financial integration makes changes swifter and imbalances more difficult to control at a country's level only. Some kind of common coordination is called into action, especially in the financial sector, but financial regulation as to capital flows can be problematic.

In the light of this discussion, we can try to trace the main imbalances that arose in the EMU after its start. A view on the European sovereign debt crisis emphasizes that countries in the South of the Euro-area were fiscally irresponsible and failed to implement pro-competitive supply side policies. This is the most common view of existing imbalances. However, it can be challenged by analyzing the other macroeconomic imbalances, which reveal other aspects and different responsibilities. In fact, the crisis reflected a deep divide between the external (but also fiscal) surpluses of the North and external deficits of the South, associated to external deficits in some countries of the latter only.

The general picture of most EMU countries up to 2007 can be depicted as follows, by grouping them under three types (using the abbreviations of their name):

1. In a group of countries (D, NL, A) a private credit problem was originated by their low inflation rates, which - given the equal nominal interest rates - gave an incentive to lend abroad to other EMU countries. The counterpart to this were current account surpluses, which arose out of tight fiscal policies and the lower inflation profile, which added to competiveness in all these countries. In some cases, as in Germany, we can speak of a true export-led strategy favoured by both private (unions and firms) and public institutions. Initial imbalances in the public sector in some countries (Germany) were ruled out over time.
2. The second group (GR, P and, possibly, IT) includes countries with fiscal profligacy and high inflation rates, which, on the one hand, led to current account deficits and, on the other, stimulated (or derived from) excess investment over savings, associated to asset bubbles. This exemplifies a case of debt-led growth.
3. In the third group (S, IR) there was no fiscal profligacy, even if the high inflation rates led to capital account surpluses (and thus deficits in terms of current account) and excess investment over savings, associated to asset bubbles. This is again a case of debt-led growth. In these peripheral countries, public deficit and debt tended to fall more than in some countries of the core, such as France and Germany.

This shows that the drivers of growth in the EMU were two, export and debt (both private and public). It also shows that not all the governments of peripheral countries accumulated or increased public imbalances, which is true for those of group 2 above, not for group 3. This negates the view of the European sovereign debt crisis as due to countries in the peripheral countries that were fiscally irresponsible and failed to implement pro-competitive supply side policies. Such a view is absolutely partial. Our analysis reveals that the crisis reflected a deep divide between the external current account surpluses of the lower-inflation countries and external deficits of the others as large as the divide between the fiscally profligate economies and the fiscally thrifty economies. In fact, from some point of view one could reverse the argument. The main common driving factor can be indicated in the foreign account imbalances, to which fiscal profligacy added in some- but not all - peripheral countries. As to the foreign imbalances, there was a deficit everywhere in peripheral countries and a surplus in the core. (Figure 1) offers a picture of some of the peripheral countries, on the one side, and Germany, on the other. France was in between the two groups and tended to behave like the periphery. Thriftiness of core countries added to the fiscal restraint of most of them. As an example of this thriftiness, the situation of Germany should be examined (Figure 2). This country had an excess of total demand over domestic demand, which derived from its export-led strategy propelled by its wage policy. This is in strong contrast with the opposite situation that emerged from the expansionary domestic policy following the re-unification with the Eastern lander. Find that a 1 per cent reduction in the wage share of GDP leads to a 0.2 per cent decrease of GDP [1]. German wage moderation can have had also this effect of lowering domestic demand, while propelling export growth [2]. Consider that wage increases in Germany after 1999 and before 2007 have always been below the 2 per cent level of the maximum medium-run inflation rate target set by the ECB and in some years they have even been lower than 1 per cent – an effect also of decentralization of wage bargaining and exploitation of lower-paid (sometimes immigrant) workers [3].

The picture can be seen also from the symmetric point of view of capital account balances. Accumulation of debt by the Greek 'sinners' does not have a pendant in terms of French and German

'saints'. Opposing a sin of those that borrowed is the sin of lenders, which irresponsibly lent their money to unlikely solvent banks. Also from this point of view, one can say that 'it takes two to tango'. Looking at capital flows directed from low- to high-inflation countries the most relevant aspect was the huge increase in net capital flows and the accumulation of one-sided net capital positions of some countries vis-à-vis others. This derived from the equal nominal interest rate – the outcome of a single monetary policy and disappearance of currency risks in the perception of investors – to which corresponded different inflation rates, and thus different real interest rates, in the various countries. This raised (lowered) investment and domestic demand and stimulated capital outflows (inflows) in higher-(lower-) inflation countries. The functioning of such a mechanism is illustrated by the two specular dynamics of private indebtedness in deficit countries and banks' exposure in surplus countries, helped by financial integration. Credit booms and asset-price bubbles in the former provided banks in the latter with strong incentives to increase their lending. Evidence has been found that, after the introduction of the euro, banks in surplus countries increased their borrowing from outside the EMU in order to increase their lending to the deficit countries within the EMU. This increased the fragility of the whole banking sector. By contrast, the role of competitiveness seems to have diminished. Before commenting the situation further, one could ask whether there was some kind of priority between the two aspects of foreign imbalances: current and capital account. These should be symmetric, but the question can be useful to put in order to understand if there was a prevailing direction of causality that might have shaped further development of imbalances.

One of the common factors stimulating both current and capital account imbalances is inflation divergence between the EMU countries, but significant divergences in inflation trends could have been more a consequence than a cause of current account imbalances [4]. These would have been triggered by capital flows, reacting to inflation differentials. The increase in net capital flows acted as an internal system of transfers, operating through the private sector via financial markets rather than through a common fiscal capacity, but the effects were quite similar. The transfers allowed a reduction in unemployment in peripheral countries and contributed to higher inflation and to asset bubbles there, thus avoiding a deflationary environment. This had a kind of multiplier effect on itself, as behind inflation there were not only – or mainly - inefficiencies, but also the asset bubbles created by capital inflows. (To both fiscal profligacy in some countries is to add.). One of the lessons is that there had been policy failures that could (or should) not be rectified by fiscal consolidations alone; policies to enhance competitiveness, financial regulation and activist monetary policies would have been just as important or more. Another lesson has to do with the unbalanced view about imbalances. According to De Grauwe, 'what is surprising is that the European Commission accepted to become the agent of the creditor nations in the Euro-area – pushing austerity as the instrument to safeguard the interest of these nations' [5]. As a result of the prevailing line, the debtor nations have borne 'the full brunt of the adjustment', by reducing wages and prices relative to the creditor countries (an 'internal devaluation') as well as internal demand, without compensating internal revaluations and demand stimulus by Northern countries. Reduction in output and employment in the Southern countries thus followed.

The imbalances were of a kind that could not be overcome easily. There was indeed no mechanism embedded in the EMU – of the kind at work in a fixed (possibly, adjustable) exchange rate standard – to do that. In the gold standard an inflow of currency in the country experiencing a current account surplus would lead to higher prices there, which – in turn – would have reduced the surplus. From another point of view, referring to international capital movements, imbalances did not tend to disappear, possibly generating the changes that would eventually rebalance the situation, in terms of capital endowment and growth. This was in particular due to the destination of capital in peripheral countries, where it was mainly directed to non-productive or less productive sectors and generated bubbles. Imbalances left the deficit countries vulnerable to a sudden capital stop or reversal of capital flows. In fact, investors from surplus countries decided that supplying finance to deficit countries had become too risky when the financial crisis hit the EA and governments had to save ailing banks. At that point, both the public and private debt had become high enough to threaten non-repayment and possible default. Thus, currency zones rather than solving the problem of international (or regional) payments imbalances make even harder to solve it, in the absence of other common institutions. Increased competition may reduce inflation, but does not guarantee growth convergence. Therefore, a common currency does not eliminate the need for internal adjustments. The point is that the situation described above is fragile and any financial stress can disrupt the precarious equilibrium, putting pressure on the high-inflation countries that have attracted international capital flows to balance their trade deficits. Official documents by the European Commission and analytical contributions by some economists, e.g. Blanchard, Giavazzi, claimed that policymakers could feel safe to ignore any current account imbalances, as capital movements would always equalize the balance of payments, which will no longer be a constraint to policy [6]. Once the imbalances manifested themselves, EMU policymakers adopted a position of benign neglect and did not remove their roots.

At most, some countries thought they should try to resolve these imbalances on their own, as in the case of Germany, but the strategy they implemented aggravated other countries' problems.

Some countries did not carry out policies of reform, either because the signals asking for them were feeble or as they preferred higher employment in the short run, and introduced only short-run labour market reforms to restrain appreciation in their real exchange rate. This was done in some higher-inflation EMU countries like Ireland, Spain and Italy. However, these policies did not significantly reduce inflation differentials until recently, possibly because they were not far-reaching and ambitious or, more likely, because supply-side reforms do more harm than good in a situation of low aggregate demand. Greece neither shrank its budget deficit, as required by the SGP, nor enacted labour market reforms, which might help to explain its misleading growth and the strength of the tensions accumulated there. Indeed, there are several reasons that can explain the failure of the policies undertaken by peripheral countries. First, often reforms were not effective or properly implemented in some countries. In addition, as the divergence has two sides, catching up with Germany was difficult, since the dynamics of unit labour costs and non-wage costs in this country was trimmed well below the EMU average. This began as early as in 1999, to cope with the stagnation that inevitably followed the reconstruction of this country after unification and the ensuing monetary contraction. This of course meant beggar-thy-neighbour policies with respect to the rest of the Euro-area. Finally and most importantly, to be effective, such reforms should have been designed as complements to proper (i.e., not so restrictive) monetary institutions and labour market and industrial policies (such as: coordination and common guidelines on wage bargaining; policies to foster innovation and industrial restructuring). These either were out of reach of each country (as for monetary policy) or were not featured in the EMU design and peripheral countries did not enact the policies they still controlled. The potential crisis became reality also due to the absence of any common financial supervisor, regulator or rescue body. This absence made it possible for the bubble to grow and burst following a financial crisis largely imported from the US: saving financial intermediaries required intervention of national governments and an increase in public deficits, thus threatening the entire European financial system. The booms or, at least, growth-sustaining bubbles in higher-inflation countries can at least partially explain why policymakers did not implement long-term policies for addressing imbalances in these countries. The 'system of signals' at the European level that would trigger action from local policymakers was imperfect. Either it did not make the signals of a possible crisis apparent to the agents involved, or the circumstances did not allow them (or persuade them) to implement appropriate reforms. Proper institutions should instead contain signals for guiding private and public agents towards the elimination of imbalances. Optimistic predictions made it more difficult to detect the need to do so, not only for ordinary people, but also for most analysts, as the 'doctrine' about the EMU tended to justify absence of correcting interventions by national governments. Optimistic assessment of an ongoing trend towards integration and convergence between the member countries pervaded financial markets.

Theoretical Roots and Practical Interests behind the EMU Institutions

Behind the institutional set-up of the EMU there are some original 'biases' that derive from two roots. One has to do with the theoretical orientation that had developed before the Maastricht Treaty since the end of the 1960s. The essence of the credo it inspired was based on the virtues of free markets and policy rules, contrasting with the ineffectiveness and inefficiency of discretionary government action. This credo was channelled to the European public and the governments through experts and political élites, in particular the monetary and financial élites and central bankers. These 'were keen to limit the discussion about EMU to the narrow focus of monetary and financial affairs', promoting consensus over the merits of macro-economic discipline, price stability and central bank independence from politicians [7]. The treaties designing its institutions, in fact, embed the principles of the neo-liberal doctrine. Depict EU institutions as the fruit of a true Berlin-Washington Consensus, reproducing – and in some cases anticipating the Washington Consensus [8]. Such principles have been shown later to be theoretically flawed, as we will see below. In fact, in prescribing structural and deflationary policies, they do not consider, e.g., the link between current output and potential output, thus condemning the Euro-area to lasting low growth. Suffice it to say here that the pre-dominant theoretical influence were those of monetarism and the rational expectations theory, not of the theory of optimal currency areas. However, the institutional design was inconsistent with respect to the monetarist credo. Remember, in fact, that Friedman himself and many other economists had manifested their reserves and critiques in particular vis-a-vis adoption of fixed exchange rates and the EMU. The other bias of the EMU design derives from the sectional and country interests that promoted its implementation or benefitted from it, also when the various elements of the theoretical setting were criticized or became obsolete. In fact, this appears to be largely unfounded now, in the light of the analytical developments of the following decades. Obviously, the two biases are linked one to another. Nevertheless, one can clearly trace the predominant vision that led to adoption of an institutional set up based on rules, rigor, and market (rather than flexibility and adaptability), on the one hand, and the interests at play both in the institutional set up and policy actions especially after the emergence of the financial crisis, on the other hand. The next sub-section deals with the arguments

sustaining a large role of markets, whereas sub-section 3.2 analyses those against government action.

The virtues of markets in a currency union

A growing consensus emerged among economists since the end of the 1960s on the failure of Keynesian policies as well as on the virtues of neo-liberal policies and 'sound' money for reducing inflation and unemployment, while raising growth rates. The institutional design of the EMU fully reflected this exaggerated confidence in the operation of markets within a single currency and negative preconceptions about the action of government. By looking at the report 'One market, one money' (and the background studies prepared for it), which evaluated the benefits and costs (indeed, the former more than the latter, in the perspective of the report) to be derived from the EMU, one can see how profoundly this assessment and the track suggested for monetary unification were influenced by the then dominant theories (European Commission, 1990). But explicitly recognizes the importance of the debate in the 1970s and 1980s and of the theories then prevailing on the EMU construction, in addition to the decisive influence of the national central banks, in particular the Bundesbank [9]. The theoretical foundations of EMU institutions can thus be traced back, apart from the theory of the OCA, to a number of analytical contributions introduced, mostly, since the second half of the 1960s up to mid-1980s. However, tracing the theoretical roots of EMU institutions can be done only in an approximate way, as they have to do with an array of rules that were agreed upon in a rather long period, partially as a result of compromises and bargaining. Thus, there may be several possible rationales for this institutional set up and more than one theoretical approach can often be linked to the real institutional architecture that has been devised. The basic idea of the European construction was that benefits could be derived from implementation of free markets, not only of goods, but also of capital in order to ensure efficiency and proper policy action. The many static and dynamic failures plaguing these markets were disregarded. Still in 2007, it was firmly believed that markets 'normally lead more immediate benefits with much less uncertainty' [10]. The process of liberalization of these markets – in particular of the market for capital – was rapidly accomplished, being completed by the end of the 1990s. By simply adding a single money to a unitary market could solve most problems deriving from the (possibly) diverging conduct of private agents in each sub-market, keeping also undisciplined public agents in line. However, given the power of command of the latter, together with scarce effectiveness of their instruments as well as the potential dangers that could result from their use, adding constraints on their conduct was necessary. Summarizes the rebalancing institutions or channels that should work in a currency union to ensure efficient allocation of resources and avoid the costs deriving from asymmetric shocks as follows: (1) domestic wage and price adjustments; (2) interregional migration; (3) interregional flows of private and public capital, ensuring operation of risk-sharing, a softer requirement for rebalancing than (1) and (2); and (4) interregional fiscal transfers [11].

However, each channel has its limits, which are either political or economic. As to the first channel, from a practical point of view, it operates, and operated in our case, only to some extent. Since labour markets tend to remain sticky, working of this channel becomes a policy target rather than a condition. With reference to flexibility in the product markets, competition and intervention by EMU authorities to restore it may be needed. Competition policy is a cornerstone of the EU design since the very beginning of the Common Market. The initial inspiration is clearly liberal, but this policy should have pursued more than one target at a time, which charged it with too much weight. Its implementation has drawn at times from the conception of the Freiburg School and in other cases from that of the Chicago School, as there is scarcely a single coherent goal of EU competition. Certainly, pursuit of allocative efficiency is one such goal, at times the prevailing one. Then, price flexibility too in not ensured. Channel (2) did not operate between countries, for economic, cultural and linguistic barriers and conveys mixed blessing. In fact, it can cause deprivation of the countries hit by shocks of their best human capital, if outflows of migrants are not temporary. In addition, according to some sources it can raise problems of equity deriving from access of immigrants to welfare state provisions paid by presumably higher-skilled native workers. As to capital movements and international risk sharing (channel 3), the experience at a world level accumulated in the 1990s (and the ensuing evolution of the literature), as well as the financial crisis begun in 2007 showed that this rebalancing channel was subject to theoretical objections and practical failures. We will refer to the former below. Channel (4) does not refer to markets properly, but was not implemented for political reasons (opposition of some countries to devolving the fiscal lever to common institutions) and the operation of markets was deemed to be a good substitute for it. Thus, the conditions for rebalancing did not operate or found obstacles to their operation. Government is the beast: finding the appropriate setting for the central bank. In the vision of the EMU architects, problems do not come from markets, which should indeed be freed of any obstacle (at least of most regulations and obstacles deriving from government action), a position that received public support and consensus without much scrutiny [12,13].

Problems come from discretionary action of public agents, as in each period these tend to pursue targets that are unattainable in the presence of private agents having either backward- or forward-looking expectations. If expectations are backward, some targets

can be met only in the short run [14,15]. With forward-looking expectations, governments are immediately fooled by the private sector and a suboptimal outcome results also in the short run: discretionary monetary and fiscal policies are ineffective with respect to real variables and the first best desired by public agents can never be obtained [16,17]. Time inconsistency then arises. However, complying with some kind of rules can at least ensure a second-best outcome. An alternative is for the constituency or government to delegate monetary policy to a conservative central banker, i.e. to a banker assigning employment a lower weight than the societies or the governments. Rogoff shows that this banker would be able to attain a lower level of inflation without reducing employment [18]. Thus, rules are a way to cope with a more general problem faced by governments, that of their credibility. Once price stability is not in question – since a rule has been introduced prescribing its pursuit, setting a cap on the inflation rate - stabilization policies are possible. This is exactly the description of the status of the ECB, which has to guarantee a certain inflation rate in the medium run as its pre-eminent target, but can also pursue other objectives, provided that these do not compromise the attainment of its predominant one. The rules for fiscal policy set by the EMU have numerous theoretical roots, apart from the need for commitment to avoid time inconsistency, an argument that can be applied not only to monetary policy, but also to any other public action and, thus, also to fiscal policy. These roots range from political economy contributions to the ineffectiveness of fiscal policy due to the low values of multipliers and the negative effects on the price level of fiscal action coordination between countries.

Political economy contributions can first offer an analytical justification for the assumption underlying Barro, Gordon's model, according to which the government's desired unemployment rate is lower than the natural one [19]. In this way, one goes to the roots of time inconsistency. These theories can explain the populist or egoistic tendencies of politicians who aim at maintaining or gaining power or exploiting it to their personal interests or in favour of other people and the need to limit such tendencies. This visual angle is useful both for understanding the theoretical bases of the EMU monetary policy and for explaining introduction of fiscal policy rules in the institutional set up. Moreover, this literature can explain the tendency of discretionary fiscal action towards accumulation of public deficit and debt, which offers an additional specific justification for constraints imposed on it. Ineffectiveness of this action due to low values of multipliers and the high value of debt goes in the same direction. In addition, the negative spillovers on the real interest rates in other member countries deriving from fiscal deficits in one country should be considered. Finally, the possible negative influence of fiscal action coordinated between countries, the worsening of the strategic position of the central bank, due to the elimination of the disciplinary effect of its action or (alternatively) the capacity of monetary counter-action justify absence of fiscal coordination and application of the principle of subsidiarity to this matter. Then, in the years preceding the constitution of the EMU the economic rationales are laid in favour of limits to national fiscal policy against its coordination within the Union. The SGP was only the legal transposition of these statements, reflecting the idea that the true problems of the EMU set up were not only that of designing an independent and conservative central bank but also of ensuring that no harm could derive from fiscal policy.

Why are European policymakers still slave of economic theories fashionable in the Seventies? Physiological lags and the role of interests at stake

Differently from the US, neither the theoretical progress of the 1990s and the following decades nor the depth of the crisis that has hit the EMU countries have produced a substantial change in the institutional architecture of EMU and current policy attitudes. The deflationary bias of the former has even been stressed by the fiscal compact. There are four reasons at least why the role of theories in the EMU construction and the revision of its institutions should not be emphasised. The first has to do with the fact that some of the skeptics at the time when the EMU was devised and then started its existence became convinced of its design after the 'successes of the first ten years of existence. On the opposite side, the progress of the theories does not appear to have been the main reason why more recently some analysts (only a few, really) moved to doubt about the soundness of the European construction, even if it is difficult to disentangle theoretical orientations from other determinants of political attitudes. McNamara is rather drastic on this. In the absence of any 'theoretical alternative or national template', it were some practical failures, such as the feeble growth and the inability of institutions to cope with current problems, their distributional effects, the disarray of the SGP, etc. that originated skepticism in the most acute observers, elites and some political parties. Others find that not macroeconomic variables, but other factors, affected support for the EU before accession. Citizens attributed responsibility to the EU and not to their country for the state of the economy in terms of unemployment and inflation after 2004, thus reallocating responsibility to the new ruler when this was really in charge of power. The waves of Euroskepticism and Europhoria both among and within EU member states are instead the object of Olsson [20]. This author suggests that the support for the EU can derive (to a variable extent) from minority nationalist, or regions with strong identity that seek to bypass their central states in order to achieve their policy goals at the EU level. Results by Olsson and others support at least in part our idea that people were in favour of the EMU before its institution and in peripheral

countries they had an incentive to comply with the admission requirements.

The second reason for downgrading the role of theories derives from the observation that not only the theories developed since the end of the 1960s were known also in Continental Europe at the time when European institutions were devised (especially on the occasion of the Maastricht Treaty). Also the OCA theory was well known. Prescriptions of this theory – right or wrong they were - were neglected, which justifies why authoritative commentators of the recent performance of the EMU have spoken of a kind of 'vindication' of the OCA theory [21]. Then, adoption of the specific institutions of EMU – free markets and a single currency centered on an independent and conservative central bank, to the exclusion of other common institutions – appears somewhat strange and contradictory, if we look at the EMU as a heritage of the economic theories of the time only. The third reason is that it is well known that policy actions only partly depend on (changes in) economic theory. There are a number of other factors explaining why theoretical innovations may not translate into adopted policies: among them, the role of inertial factors. In addition, the evolution of real phenomena can have an impact on policy action. Similarly to the empirical foundations of the Bretton Woods agreements and their rejection in the in 1970s, adoption of a currency area can be seen as the product of the 'impossible trinity', deriving from the increase in capital mobility. Finally, vested interests and some autonomy in the dynamics of political orientations can explain policy actions, even if it is quite a difficult task to separate their role from that of theoretical orientations and say anything about the specific role of interests when assessing the success of some ideas. Keeping them separate from theoretical arguments can only be done as a first approximation, as interests and ideas are not mutually exclusive and often interact simultaneously or sequentially [22]. Considerations of political economy on the possible influence of vested interests and the different bargaining power of the various countries, especially those having a strong currency, as well as reflections of a non-strictly economic nature, would be in order. These are largely outside the realm of the present paper, but we deal here with some of them briefly. With this proviso, one could accept at least the plausibility of some positions according to which the preference for a deflationary environment featuring the EMU was the outcome of rational choice of the export-oriented members and their bargaining power in the Eurozone, not of an irrational rejection of Keynesianism. The truth may be that both these explanations could be right: on the one side, the interests of German producers could favour a deflationary attitude; on the other, widely diffuse anti-Keynesian doctrines in Germany (and a neo-mercantilistic attitude, well rooted in the history of economic ideas and actions) could have favoured acceptance of producers' interests. Some authors represent the interaction and clash of ideology and structural features and interests in the EU Council of ministers. By examining the position taken over years in the Council by each country, they conclude that rich countries do not usually oppose suggested policies in favour of integration, as they are more interested in facilitating it, whereas minor countries tend to show their opposition under the influence of some domestic lobby, by abstaining or voting against proposals arriving at the Council. In our opinion, while this is indicative of opposing interests, there may be a bias, as rich countries have the power to facilitate the path to have their proposals discussed in it.

The antecedents of the Delors Report and the Single Act are well represented by Gros and Thygesen: a French and an Italian memorandum had criticized the bias of the EMS against 'deficit' countries as well absence in this system of mechanisms designed to achieve structural change and growth. The German answer was of a monetarist kind, in asking for monetary unification and the establishment of a central bank having price stability as its preeminent target and capable of acting as 'catalysts in the efforts to achieve the necessary convergence of economic policies in the member states' [23,24]. The German reply, anticipating real developments in the European institutional architecture, was thus closely linked to the theoretical innovations since the end of the 1960s as well as to the traditional stance of the Bundesbank as independent from political bodies since its start and pursuing the priority target of low inflation. The effectiveness of the German position was heavily influenced by some practical circumstances that had matured in the previous two decades. Notable was the rising weight and bargaining power of Germany among European countries, due to its rapid growth and – after 1989 - unification with Eastern Lander. This country was thus able to pursue its low interest in implementing appropriate policies to close long-run divergences in economic performance between countries, while relying on markets and institutions that tended primarily to price stability and adjustment by peripheral countries. German dominance – or, at least, its leadership - in the EMS, expressed by its ability to implement an independent monetary policy, as well as the conduct of the other countries that followed it, is well documented. Karl Otto Pohl, the Bundesbank president from 1979 to 1991, said: 'The Bundesbank turned the original concept [of the EMS] on its head by making the strongest currency the yardstick for the system' [25]. However, there were different positions as between the different German institutions. In fact, some authors underline the conflict of the Government with the Bundesbank in the implementation of the EMS. For this reason one must be careful in attributing positions of specific Germany institutions to the country as a whole. According to some authors Sadeh, Verdun, Germany did not act as a leader, except during crises [26]. Monetary authorities neither sought to 'lead' nor is there evidence

that they purposely tried to influence other monetary authorities, except perhaps for crisis episodes. In fact, the Bundesbank objected to the EMS from the outset, and obtained the 'infamous' 'Emminger letter', which allowed it to renege on its commitments if it deemed price stability in Germany to be in danger. In securing their commitment to the EMS other monetary authorities simply followed (or paid close attention to) German monetary policies. The Bundesbank was from the outset similarly cautious about EMU, if not critical of it. It was not alone in this stance; a considerable part of the German public, both laymen and experts, were skeptical of EMU when it was being created. In December 1991, after the negotiations of the Maastricht Treaty had been completed, the Bild Zeitung ran a front-page header explaining that the end of the Deutschmark was near, which caused great distress among the population. According to McNamara, independently of whether German decision makers had or did not have a desire to dominate monetary policy in Europe, Germany never possessed the formal power to actually coerce EU member states into accepting its rules, or to punish those who break the rules. The only (formal) sanction available to Germany at the outset was not to agree to the establishment of EMU or to stay outside. In McNamara's terms, German influence did not translate into monetary dominance, as it was not a hegemonic leader in the traditional sense either during the EMS period or afterwards. In a similar way, there are claims that the European integration process was certainly the product of the will and positions of the central actors involved, but this was shaped only as a set of interlinked bargaining relations, interacting with some key rules of the game, accounting for the `fundamentals' of each country. In any case, in his opinion there was no hegemonic actor in the EA design.

This position has scarce foundation, for numerous reasons. More than exercising leadership, the position of Germany tended to affirm its authority or even dominance over regional agreements like the EMS and, later, the Union. As said, Kaelberer underlines the bargaining power of Germany over the rules of monetary cooperation due to its strong currency and, thus, absence of a reserve constraint [27]. Other authors recognize that, during the EMS, the Bundesbank had imposed its monetary discipline, which caused two effects: a positive one, as it ensured disinflation in Europe; a negative one tied to the double digit unemployment rate experienced by other European countries and the low growth rate of the whole area. There are many reasons to say that it, together with other creditor nations, has called the shots in European economic policy. Rejection of the Werner Plan and acceptance of the typical German pretense of having economic convergence before monetary unification (instead of conceiving this as the first step towards a more complete union) argue in favour of some kind of hegemonic position of Germany. In addition, one should also consider that in progress this role of Germany strengthened, in parallel with the stronger bargaining power acquired after re-unification. And this country made use of its position to be granted privileges when asking for exemptions for the violation of the SGP rules in 2003-2004, setting new institutional rules and deciding current policies. 'By breaking the rules of the SGP, France and Germany left the impression that they are free of sharing the adjustment burden, and that EMU was wanting in leadership and solidarity'. Really, the hegemonic position of Germany remained hidden, as this country preferred to remain backstage. According to Paterson, 'it was argued that an exposed leadership position would be unacceptable to other members given the history of the past century' [28]. The hegemonic role of Germany had to become manifest only after the eruption of the crisis, which 'touched on (its) elemental material interests'. Germany's transition to a 'reluctant hegemon' position thus reached the tipping point. In the most indulgent interpretation of the German 'vision' underlying the EMU construction, a common currency could integrate European economies and make them converge in due time: monetary unification could ensure the structural changes necessary for creating a stable macroeconomic context (in particular, uniform wage and price dynamics), while ensuring a looser monetary regime and allowing for German reflation. Other, less favourable, interpretations are, however, possible. One of them could simply be that Germany intended to establish an institutional architecture that should have permitted it to pursue the goals of a mercantilist monetarism and to further the interests of its savers and the banking industry or, at least, that it did at some point actually exploit the agreed institutional set up to pursue such a strategy [29]. As to institutions, in order to preserve its veto power for key future decisions, in facing new problems of common interests, Germany tended to prefer intergovernmental agreements to higher supranational powers for the EMU. In any case, its export-led model of growth made it unaffected – or little affected - by the deflationary bias of the EMU. At the same time, the specular image of its export surplus, i.e. its nature of a creditor country, empowered it with deciding the solutions for the crisis more suitable to pursue its interests.

Germany must certainly be credited to have been able to create a system powerful enough not to suffer from the deflationary bias of the EMU institutions, due to the real devaluation it operated since the 1990s, in particular in the early 2000s, and for its ability to build a successful system to compete in Europe (and outside the area) through the quality of its products [30]. However, these very credits constitute acts of distrust towards the construction of a true common institution. Germany might have some justifications for that in the inactivity of peripheral economies, but not before 2003-4. Apart from Germany, the attitudes of other countries were influenced, at least to some extent, by the assessment and the positions taken by important interest groups. According to Talani,

in the UK the financial sector was against participating to the EMU, as a way to keep its supremacy unaffected, whereas in Italy both the financial and the industry sector were interested in the long-term benefits, even if the latter feared that in the medium term it would lose the benefits of periodically devaluing the exchange rate [31]. Peripheral countries (most of the GIIPS) still think that they may draw some profit from the external constraint of fixed exchange rates and other EMU institutions. They might like reforming some of these institutions, but are not powerful enough to counter German opposition. This helps explain why they have accepted a number of institutional changes, among which the incredibly asymmetric provisions of the Macroeconomic Imbalance Procedure (MIP), which has been tailored to the German and Dutch interests. Fragmentation between the different European countries is thus rising, even if it appears to be repressed, until now. In emphasising the role of Germany and the interest of other surplus countries to create an asymmetric MIP one should not forget the many shortcomings in the conduct of peripheral countries. These tolerated inefficiencies in the public and private sectors, which have not been overcome either before the crisis or – in many cases - later, as well as the interests of the financial and construction sectors in fostering a financial-led growth with soaring asset prices. Obviously, policymakers in these countries did play an important role, in tolerating inefficiencies and the specific interests of the sectors involved, to the detriment of the interests of the whole system. This is clear, on the one hand, if one reflects on the role of self-interested politicians in being elected on the basis of a program of soft budget constraint. On the other hand, even not self-interested politicians could act in a way that ‘economically’ maximizes welfare, if the promise of a hard budget constraint was only a way to gain reputation and be admitted as members of a European club, thus accepting the prospect of a lower level of income for the area as a whole. As a consequence, Featherstone is right when he says that the vincolo esterno and EMU only encouraged a reform direction, but did not determine ‘the choice of content’ [32]. However, in our opinion he misses the point when adding that the external constraint was a means to try to internalize the norms and values of EU policies, at least in most peripheral countries. This might have been, or really was, the case before admission to EMU, when élites encouraged reforms in public administration and the private sector, as they – and the general public – expected gains from participation to the currency union. However, this does not appear to have been the case after admission, least in some of the peripheral countries cited by Featherstone, also because the vincolo esterno was not much of a constraint. As to core countries, one can also have doubts about the realism of Featherstone’s idea that they were closer to the demands of EMU, if this is to be intended as adherence to its norms and values. Otherwise, it would be difficult to reconcile this statement with pursuit by some of these countries of an export-led strategy by means of true beggar-thy-neighbour policies and their violation of agreed norms (the SGP).

The Rebuttal of the Theoretical Convictions of the 1970s and 1980s and the Theoretical Progress of the Recent Years

Many economists and observers warned about the fragility or the limits of the EMU project. Their number decreased as the Union proceeded and seemed to gain success. However, its theoretical bases soon revealed their weakness. Almost a decade ago, Alan Blinder claimed that ‘a sharp revision of the naively optimistic views (about the capacity of economic policy to control the economy) held by some economists circa 1966 was called for. But … the pendulum may have swung just a bit too far‘, producing similar naively optimistic views about the virtues of markets and the need for restraining government action [33]. Blinder’s words are even more actual nowadays as economic theory has further questioned the system of analytical conclusions and beliefs that had emerged in the twenty years or so after 1966, even if it still retains some assumptions that led to the propositions featuring that credo. Three decades later, faith in the mainstream credo would again be crowded out by the analytical developments (and some empirical findings) intervened in these years. Think of:

- the limitations re-emerged in the functioning of markets, especially capital markets, with specific reference to herd behaviour, reminding Keynes’s (1936) ‘beauty contest’, realization of conditions subject to which freedom of capital movements and the mechanism of risk sharing can be justified;
- the limited practical relevance of the surprise effect;
- the disproval of the Lucas critique, e.g., with reference to changes in structural parameters as a consequence of a change in policy rules;
- the irrelevance of many critiques to the ‘classical’ theory of economic policy (in particular, to Tinbergen’s ‘golden rule’ about controlling the economy) based on REs ;
- the theoretical and practical limits to time inconsistency when policymakers have enough instrument and thus to related prescriptions of the monetary policy rules that should replace discretionary action
- existence of a long-run non vertical Phillips curve;
- the need for a more active fiscal policy and regulation (especially of financial markets and institutions) once some unrealistic assumptions of current models are ruled out;
- critique of the arguments put forward by Rogoff in favour of political independence of central banks;

- sub-optimality of a conservative central bank in a monetary union with active trade unions, but benefits from fiscal coordination when a conservative central bank operates;
- critique of the Friedman rule and the need for an inflation target well above zero;
- empirical findings suggesting that: 1. reputation effects of tying one's hand through fixed exchange rates can be rather limited, whereas credibility depends on country policies and 'fundamentals' ; however, in the case of Greece, credibility soon emerged as a result of its participation to the EMU and the anti-inflationary attitude of the ECB (with spreads were significantly below what would be predicted by fundamentals), whereas after May 2010 actual spreads have exceeded those predicted by some 400 basis points , which makes it to doubt the ability of financial markets to make correct forecasts according to fundamentals and to be 'wardens' of proper policy conduct; 2. Countries that adopt inflation targeting have not attained better monetary policy performance relative to a control group of highly successful non-inflation targeters.

For An EMU Fostering Growth and Not Prone to Financial Crises

The first sub-section deals with some possible new goals to be considered in a reform of EMU institutions and their possible design. The second sub-section complements discussion of new goals by discussing the choice of a new growth strategy.

A new design for the EMU

The Euro-area's institutional architecture needs to be designed anew, taking account of its failures as well as the novelties in the theoretical and empirical achievements of economic analysis in the last decades. Mostly, a new contract among the member countries should be drafted, as new goals – or a redefinition of the previous goals and rebalance of their relative weights – must be agreed upon. If these new targets are accepted, with a reduction in the relevance of monetary stability, a higher weight on employment, growth, financial stability and fairness, reasoning on the most appropriate reforms and instruments is easier. In order to complete the indication of macroeconomic goals, let us consider the case where different - and possibly opposing - strategies are independently pursued by each country. Recalling their essential traits could be useful. We refer in particular to the case of decentralized decisions on wage dynamics. Keeping nominal wage growth below productivity (as Germany has done for decades) tends to raise profits and lower the wage share, thus reducing domestic demand (because of the negative effects on consumption), if there is no corresponding increase in investment. If exports increase – and such strategy of wage dynamics undoubtedly tends to give an incentive to that - the problem of a lack of aggregate demand and growth can be solved, but demand abroad in the rest of the EA will be reduced. In addition, this strategy can be pursued by one big country only in a closed economy like the EMU's. In a similar way, and as a consequence of following this strategy, if another country, running a current account deficit, borrows capital from the country with an export-led strategy, in the short run it can enjoy growth or, at least partially, counteract the negative effects of the strategy pursued by the country adopting a beggar-my-neighbour attitude. However, in the longer run it can suffer from the asymmetric shocks that arise, as these, in turn, to some extent negatively affect also the export-led country. The benefit should then be clear not only of reducing permitted current account imbalances and of making them symmetric (which completes the tetralogy of macroeconomic targets to pursue), but also of searching for a common strategy.

More generally, a complete and satisfying re-design would require:

- Institutional reforms putting less emphasis on the virtues of the operation of markets and the common currency.
- Institutions and policies allowing for the emergence of the conditions that ensure the validity of the OCA. They must be created, not so much by states in terms of labour market flexibility (especially in times of crisis), but at the EMU level, by completing the union with federal institutions and policies that would make the EMU to eventually fit the conditions for an OCA, such as a fiscal union and the central bank as a lender of last resort for governments.
- A change in the ECB goals and statute, starting from the redefinition of the inflation target, to set a higher ceiling, downgrading the predominant role of anti-inflationary policies in a way to leave more room for the employment and financial stability goals, in a way similar to the Federal Reserve. Also the model of the Bank of England could be followed, with no political independence and the goals of inflation, set, in our case, on an annual basis by the European Commission.
- An increased role of other common policies, in particular fiscal policy. The common budget should thus be increased in order to permit anti-cyclical action as well as to design common investment strategies to foster a uniform growth throughout the Union. The budget should perform a stabilization role proper (for symmetric shocks) and an insurance function (for asymmetric shocks). A common welfare system, and other microeconomic policies, should be devised to make structural adjustments of the economies possible in the direction of a higher efficiency. This, again, requires an increase in the size of the common budget. Macroeconomic policies to reduce the existing asymmetric

actions foreseen in the macroeconomic imbalance procedure devised in 2011 should also be enacted.

- Institution of a system of incentives to change, as the one suggested by Steinbach [34]. This author proposes to redesign treaties and statutes by introducing either contractual agreements between the EU and individual Member States, underpinned by financial support offering an incentive, or mutual agreements concluded between Member States for the implementation of structural reforms. The Excessive Deficit Procedure does not offer incentives and sanctions to countries better than those of market-based interest rates.

Redesign of the EA along these lines would not be an easy task. Political objections would be numerous to both their basic tenets and their specific structure and features. They would be raised by governments and other public institutions of many countries – such as the Bundesbank - and political parties. Recently, however, timid openings for a change of the current structure have emerged. These are contained in the documents, speeches and declarations of the representatives of the ECB and the new European Commission (Juncker Plan) as well as in the practical implementation of innovative policies, as in the case of unconventional monetary policies and a banking union. Most likely, the necessity of the reforms outlined above could be more widely recognized if reforms were diluted through time and a rather long path to their final realization were devised. This implies that their main body would be implemented only with the next generation or two. However, it would be important to realize their need and agree on a timetable right now.

A common growth strategy instead of competitive countries' strategies

Possibly, one of the main implications of the analysis in the previous section is the need to reverse the previous trend of member countries, with their different and often conflicting strategies, by adopting a common strategy of growth. The various types of imbalances within the Union derive precisely from the adoption of different strategies of growth as between the member countries, i.e. an export-led growth by Germany and a credit-led growth, fruit of a kind of short-sighted, misguiding strategy of domestic growth based on the expansion of less efficient and productive tertiary sectors, notably credit, constructions and, sometimes, public sector deficits. This dual strategy had a negative influence on imbalances and implied low growth and the possibility of crises in the Union as a whole. To avoid these negative effects a strategy of reconstruction and redesign of the EA institutions should be devised from a short-term, a medium-term and a long-term perspective. A common strategy would require that in the medium term, internal imbalances in both the current account and the public sector should be reduced. As to the current account, the MIB should be amended, by making imbalances symmetric and reducing their size. Rebalancing can take place through either inflation and expansion of demand in the former or deflation and contraction in the latter or both. The common growth strategy could be supported by Eurobonds, an initiative usually ascribed to Jacques Delors - i.e., issuance of 'Union Bonds' to finance infrastructure investment. They could be issued not only in order to mutualise part of the outstanding debt and stabilize financial markets, but also to complement expansionary fiscal policy. All new Euro Area sovereign borrowing could be in the form of jointly guaranteed Eurobonds. Some authors propose limiting the EU guarantee, in order to induce the government to reduce debt, and make it conditional on the implementation of sufficient structural reformism, privatisations, opening up of product markets, more flexible labour markets and increased efficiency for public good provision. New financial instruments especially dedicated to social infrastructure, such as social bonds, could also be issued in order to finance EU-wide social investments. In practice, in November 2012 a framework for the issuance of 'Project bonds' has been approved. These are a financial instrument launched by the European Commission and the European Investment Bank as an innovative response to the needs for investment in large EU infrastructure projects, as a part of the Europe 2020 Project. Also the EU Commission has also suggested some guidelines for the introduction of 'Stability Eurobonds' that could reduce and share the default risk.

For A Democratic EMU Not Prone To Country or Sectional Interests

An important preliminary clarification is needed about the meaning of the term 'democratic' institution. Democracy can be seen from a 'collective' or an 'egalitarian' perspective. The former emphasizes the possibility for a people – in this case, the EA constituency - to elect its governing institutions. The latter is less demanding, as it preserves self-government of countries, but also suggests integration of policies and accountability of international institutions [35]. According to Eleftheriadis, the EU is only a union of peoples, which can become more democratic, even if it cannot become a democracy. If in the short run we can accept this position, it must be said that the dream of the founding fathers of Europe tended certainly more to the goal of a European people. This dream can require time, but it is important to have in mind some kind of path that can lead to its implementation. The EU Commission has introduced a system of contacts with various stakeholders, trying to develop a method of consensus. However, this has involved mainly the élites and has not ensured the necessary transparency. Majone speaks of a kind of 'democratic default' in the Union,

which arose over time, starting with the failure of the CAP, continuing with that of the Lisbon Strategy and ending with the misconduct in the prevention of, and response to, the financial crisis [36]. Then the issue arises of how to combine democracy with other requirements of a heterogeneous Europe and the different positions and abilities of each country. Only from solutions respecting all these requirements can a viable and democratic Europe spring [37]. It must be said that responding to the demands of people and countries has become very difficult in Europe after the crisis, as this has implied a return of the primacy of narrow economic interests in the European governance, together with a good dose of confusion. In the words of De Wilde, now 'different "Europes" are demanded by different people, in different settings, different countries and even by the same people at different times' [38]. In any case, democracy would require less involvement in policy decisions and in the ability to punish of unelected people, such as those governing the EU Commission and the ECB, and markets [39]. De Grauwe says that '(n) either the European Commission or the other members of the Council face political sanctions for the measures they impose on one member country. The principle of "no taxation without representation" lies at the heart of democracy. The SGP has been an attempt to short-circuit this principle, by giving powers to individuals and institutions that do not face the political consequences of their actions. Such an attempt has to fail and happily so'. Also according to Schelkle, issues of democracy arise in the EU [40]. In fact, against the position that has led to 'keeping politicization out' there are good arguments in favour of 'bringing politics back in', as this would 'halt growing apathy or outright hostility towards the emerging European polity' or, at least, contribute to that [41]. Schelkle's reasoning seems to be even more relevant facing the growing populism in European countries. To overcome apathy and populism also more transparency of the process leading to decisions is needed.

Some kind of 'deliberative supranationalism' (at least in the transitional phase before a federation or the goal of a European people can be established) would be required also in order to face conflicts between countries. In fact, both country and sectional (often conflicting) interests play now a relevant role in EU governance. As to the latter, policymakers' personal preferences or the sectoral interests influencing them fill in the space between input participation by the people and output, in terms of policy effects in favour of people. This can be hindered by people's participation to governance, which can ensure transparency, accountability and inclusiveness, thus contributing to a better outcome [42]. However, in the words of Nicoli, the EU misses the necessary 'convergence of identities' [43]. This generates a number of problems of governance in the Euro Area, which are at the root of the pains related to the crisis. In a nutshell, the missing 'convergence of identities' makes it difficult to build a federal entity and, almost as a reflection of this, in the Union a series of partial powers exist that are often attributed to unelected institutions or are often blocked by veto powers. As to country interests, one case may be of particular significance: '(w) hile EMU's domestic demand-led models are forced to pursue painful austerity measures that have reduced inflation and increased unemployment, no attempt has been made to correct the excessive levels of wage moderation in the EMU north, specifically Germany, which undermined the periphery's lack of competitiveness in the euro's first decade. The result of the EU's policy response, which has been shaped in the shadow of German hierarchy, has been to establish an asymmetric low-growth equilibrium within Europe that exclusively penalizes its southern rim' [44]. The different size of countries and the asymmetry of power between 'creditor' and 'debtor' countries in the management of the EA crisis and the ongoing institutional reform process of EMU have brought the issue of German dominance in Europe back to the forefront of scholarly debate. Germany has pursued the interests of its savers by shifting the burden of adjustment deriving from the financial crisis on debtor countries, as is clear from the policies imposed on Greece. However, at least on this occasion, France and Italy have shared the same attitude. Also in the case of the ECB policies to relieve the EA from the ensuing recession, the Bundesbank and, to some extent, the German government have pushed against unconventional policies, expansionary fiscal policy and rising inflation, in order to protect the interests of German savers. In this circumstance, the ECB has taken a firm position, favoured by its independence. However, this situation is no longer tolerable and a more balanced governance should be implemented. Creating a common finance minister for the whole EA could to some extent increase the coordination of macroeconomic policies, while raising other institutional issues. Alternatively, a Fiscal Council could be charged with the task.

Some steps for pursuing economic and political goals over the next years are indicated in the paper recently prepared by the EU Commission [45]. It covers issues such as banking and capital markets unification, economic and social convergence, preparation of the new Multiannual financial framework, the fiscal stabilization function, in addition to those of democratic accountability and effective governance. There are different projects for the periods 2017-2019 and 2020-2025. The democratic deficit of the EU should properly be fixed. The situation could be improved by implementing some minimal rules, such as more transparency concerning the motivations and effects of decisions, with specific reference to the categories of people that would benefit and those that would be hit. A range of reforms oscillate between a minimalist and a maximalist perspective. To exemplify, let us refer first to governing bodies. The European Commission could be

elected either indirectly via the European Parliament or directly by the EU citizens. As to the ECB, in confirming its independence one can think of subjecting it to oversight, either by the EU Parliament and the EuroGroup and/or also by national parliaments of member countries. Finally, bailout funds and austerity programs can be subject to approval and scrutiny by national parliaments or referendums ratifying them. A solution to the democratic deficit would require not only a change in the orientation and the modes of current decisions, but also and mainly a radical change in the institutional setting of the EMU. This would be difficult to implement in the absence of a process of 're-envisioning of the EU's socio-economic policy, … in concert with the people, through pluralist processes, and by the representatives of the people at both national and EU level, through more politics … In addition to the political and economic reforms, … the EU needs to re-envision its identity and change its decision rules … [in particular] by eliminating the unanimity rule' [46-62]. A democratic state must respect the will of its citizens, but also be efficient. From this point of view, a number of reforms of the Euro Area are in order. From a methodologic point of view, a starting point is offered by existing institutions, in the process to changing them in the directions we have traced. Key elements can be reinvigorating the Broad Economic Policy Guidelines and the framework that guides economic policy. Some authors suggest also to extend the EU Macroeconomic Dialogue, in particular by setting up meetings at Euro Area level, by involving the Eurogroup, the peak European social partner organisations, and – at the level of Member States - the participation of national central banks, fiscal authorities and national social partners.

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