

THE IMPOSSIBLE TRINITY OF DENIAL. EUROPEAN ECONOMIC GOVERNANCE IN A CONCEPTUAL FRAMEWORK

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Abstract

The first ten years of the Economic and Monetary Union were a remarkable success story. Nevertheless, the European financial-cum-sovereign-debt-crisis made it clear that the original design of European economic governance is not feasible any longer. The crisis compelled Europeans to admit that the implicit consent of Maastricht on a triple denial with regard to the single currency area, i.e., (1) no exit, (2) no bail-out, and (3) no default, is no longer tenable. By introducing the concept of the 'impossible trinity of denial', the current paper argues that pursuing these three goals simultaneously is not attainable, and that one of these should be sacrificed in order for the single currency to survive the current crisis. Also, supranational institutions should enjoy more control over crisis resolution in the future.

Keywords: European economic governance, impossible trinity, sovereign debt crisis, sovereign default.

1. Introduction

The theory of impossible trinity dates back to the early sixties, yet it did not receive proper attention up until the eighties, a period of accelerated capital account liberalizations, which was the ultimate manifestation of economic globalization for many. Free movement of capital resulted in a substantial decline of the autonomy of central banks in countries with fixed exchange rates. Other countries preferred to keep the stabilization tools of monetary policy in their own hands, and decided, therefore, to change over to flexible exchange rates as a response to expanding capital mobility.

The term 'impossible trinity' refers to a situation where the simultaneous implementation of three desired policy goals is not possible to reach. As a consequence, one of the three objectives has to be sacrificed in order to fully attain the other two. Decision-makers are often confronted with such unpleasant situations. Accordingly, it is the responsibility of elected politicians to weigh all the costs and benefits of the different combinations of outcomes (e.g., free movement of capital and fixed exchange rates at the cost of the lost autonomy of monetary policy) and choose the one with the highest welfare improvement. The restrictive effects of economic globalization were first studied by Robert Mundell, whose model evidently demonstrated that (1) a fixed exchange rate; (2) the autonomy of the monetary policy; and (3) full capital mobility cannot be pursued at the same time (Mundell, 1968).¹

Europeans had to understand the uncompromising logic of the Mundell-Fleming model relatively early on, when they first decided to coordinate exchange rate policies on a regional level. The European Monetary System (EMR) was a mix of fixed exchange rates and autonomous central banking policies. The price they had to pay for the new regime came in the form of constrained capital mobility. As the liberalization of capital accounts became an essential pillar of the single market from the second half of the eighties onwards, countries participating in the EMR had to suffer a serious loss of autonomy in the conduct of national monetary policy. The vulnerability of the fixed exchange rate system on the one hand, and the desire to fully exploit the benefits of the single market on the other hand, induced European policy-makers to commit themselves to the establishment of the Economic and Monetary Union (EMU) later on. They decided to delegate national competencies in monetary policy onto a supra-national level, more specifically to the European Central Bank (ECB), along with the adoption of the single currency.²

The first ten years of the EMU were a remarkable success story, which made the euro one of the most widely used currencies in transactions and it also provided shel-

1 Other known impossible trinities are the political trilemma of Rodrik (2002), the globalization trilemma of Summers (1999), or one of the latest impossible trinities developed by Pisany-Ferry (2012) in the context of the EMU.

2 Adopting a single currency means that countries voluntarily give up the opportunity of manipulating the quantity of money and interest rates. Without a national *legal tender*, countries cannot apply devaluation as a means of economic stabilization, either.

ter for countries at both the periphery and the core (European Commission, 2008). Nevertheless, the European *financial-cum-sovereign-debt-crisis* made it undeniably clear that the original design of European economic governance is not feasible any longer. What seemed to be a fairly feasible construction in good times (*in concreto* during the years of the great moderation) turned out to be a highly vulnerable structure in bad times. The crisis compelled Europe to admit that the implicit consent of Maastricht on a triple denial with regard to the single currency area, i.e., (1) no exit, (2) no bail-out, and (3) no default, is no longer tenable. By introducing the concept of the 'impossible trinity of denial', the current paper argues that pursuing these three goals (the triple denials) is not attainable, and one of these should be sacrificed in order for the single currency to survive the current crisis.

The paper provides a critical analysis of the major ideas on the management of the current sovereign debt crisis in one single conceptual framework. Accordingly, following a short introduction, the second section provides an analysis of the costs and benefits of the exit scenario. The third section scrutinizes the option of bail-out. The fourth section studies the possibility of sovereign default. The fifth part is a detour from the strict logic of impossible trinity and provides some alternative solutions to the current crisis by focusing on the federal level, and investigates the option of a more robust involvement of the ECB.

2. The denial of exit

EMU member states have lost their autonomy over monetary and exchange rate policies. In case of a sovereign debt crisis, neither an inflationary monetary policy, nor a devaluation of the national currency can help a country to overcome its economic difficulties. The sole remedy, therefore, is the adoption of restrictive fiscal measures, which can, however, create political tensions. Consequently, incumbents may find it counterproductive to engage in tough fiscal actions. Countries unwilling to undertake the politically risky consolidation measures may volunteer to leave the euro-zone.

Whereas joining the euro-zone requires candidates to meet certain, predefined conditions (i.e., the Maastricht convergence criteria), no such explicit requirements have been articulated with regard to exiting the euro-zone in the Lisbon Treaty. In fact, no country can decide to leave the EMU, and none of the members can be expelled by the others, either. The only option for getting rid of the single currency is to abandon European Union (EU) membership altogether. Thus, it is highly unlikely that any country troubled with a sovereign debt crisis would choose such an unrealistic option.

In principle, a return to national currency may boost export and economic activity via devaluation, but it is worth noting that it would also trigger an immediate increase in debt servicing, as national assets (along with incomes) would come in (dramatically devalued) domestic currency, whereas all previously accumulated public and private debts would be still denominated in euro. As an exit amplifies uncertainty, rational households, businesses and investors would be more likely to escape from assets denominated in the re-introduced national currency. The selling of domestic currency would accelerate devaluation pressure, which can easily culminate in not

just a liquidity crisis, but also in the total collapse of the national financial system and the economy itself. In the end, it is the exit itself which pushes the troubled nation to renege on its liabilities and announce a default (Eichengreen, 2007).

Interestingly, the idea of leaving the euro-zone without abandoning EU membership has gained some degree of support within academic circles, too. Feldstein (2010) for instance proposed a holiday for Greece (i.e., a temporary return to drachma with the obligation of joining the euro-zone as soon as possible). In his view, by temporarily returning to the national currency (and the consequent devaluation of the nominal exchange rate), the country could increase its price competitiveness on the one hand and make fiscal consolidation less painful in terms of reduced employment on the other hand.³ Even if the EU was ready to allow its member states to choose partial exit (leaving the currency zone but staying within the EU), it would still not guarantee that the costs of exit would entirely diminish. Even worse, since this scenario would require the modification of the Lisbon Treaty, it would open up a time-consuming political bargaining process which could push the whole euro-zone further down the road. Albeit politicians have not ruled out entirely such a scenario, it would increase uncertainty and risk, because no one would know who would be the next in line to be forced to leave the monetary zone.⁴

In principle, if a country was able to return to its national currency without leaving the European Union, it could choose from two options with regard to its future exchange rate policy. It either joins the new European exchange rate mechanism (ERM2) after a dramatic devaluation of its national currency, or it opts for a flexible exchange rate regime. One of the advantages of the former option is that the ECB can help the country in times of shocks by intervening on behalf of the troubled country in foreign exchange markets. Moreover, the country will have the option of returning to the EMU, assuming that it has fully made use of the advantage of having a national currency and has successfully revitalized its economy. Floating, on the other hand, could – theoretically speaking – guarantee equilibrium exchange rates and help regain competitiveness. Also, the autonomy of the central bank would be extended somewhat. However, the central bank's room for maneuver largely depends on the size and openness of the troubled state and its external financing needs. Also, flexible rates may overshoot from time to time, which cause serious concern for both households and businesses.

3 See Baldwin and Wyplosz (2010) for the resentment that this proposal has triggered. Although Martin Feldstein has always been a Eurosceptic, it has definitely not been the case with Dani Rodrik, who called for a very similar 'first exit and later rejoining' solution to the euro-zone's debt crisis: 'For the moment, the euro-zone may well have reached the point where an amicable divorce is a better option than years of economic decline and political acrimony' (Rodrik, 2010).

4 Ridiculing the whole debate, Stiglitz (2010) went so far as calling Germany to quit the euro zone, since the revaluation of its national currency, the DM, would eliminate surplus in its current account *vis-à-vis* the rest of the euro-zone countries.

It is highly questionable, however, that an exit would really be able to fix anything in Greece. It is not simply the record-high level of sovereign debt that prevents the country from growth, but the lack of competitiveness and the poor quality of its public administration and national governance structure.⁵ Without the much-needed structural reforms in areas such as the banking sector, the service sector or the public sector, Greece will never be able to return to the path of sustainable growth; instead, the country will only regenerate its debt problem again and again, ending up in a dead-end street and total collapse.

3. The denial of bail-out

While the Treaty on the Functioning of the European Union is completely silent on exit, it is rather explicit and straightforward on the denial of a bail-out. It claims that

The Union shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State... A Member State shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State... (Article 125 (1))

The no-bail-out clause has been in the focus of intense and harsh debates from the very beginning of its Maastricht codification. The current crisis has significantly fuelled the debate, and a consensual interpretation seems to be further away than ever before. This is a rather unfortunate state of affairs, as the reading of Article 125 (1) undeniably determines the future of economic governance. In the mainstream interpretation,⁶ Article 125 (1) prohibits both the Union and its member states to bail out any sovereign in trouble (on early debates see Pisany-Ferry, 2006). The argument is simple and straightforward: as long as the Union is capable of isolating itself from the troubled nation, no contagion would threaten the rest of the euro zone. The founding fathers of Maastricht also wanted to ensure that market forces were ready to monitor and evaluate every member country's public finances and punish deviant behavior. It was strongly believed that financial markets could exert an influence on the fiscal policy of each member state, and as such the EU should not care about further disciplining its governments – beyond the rules of the Stability and Growth Pact. The immediate success of the single currency, however, made the financial markets relaxed. Retrospectively, the remarkable interest rate convergence of 1998 to 2007 made it evident that the previously assumed alarm mechanisms of

5 According to international institutions such as the OECD or the World Bank, Greece has in fact the most regulated and least competitive economy in the EU.

6 See especially the decision taken by the German Constitutional Court in 1993, and the most recent statements of German officials with regard to crisis resolution.

the private sector did not work at all.⁷ In fact, the euro-zone was literally considered as a *single* currency area by the financial world, without any differentiation amongst its member states. The results are quite well known by now. The lack of a strong market scrutiny induced moral hazard, and countries such as Greece did take on a free ride in terms of accumulating huge debts – which perhaps they could never have done without the euro.⁸

Others, however, have had a different reading of Article 125 (1). Marzinotto and his colleagues of the Bruegel Institute claimed for instance that the loan provided for a country in trouble should not be considered by any means as bail-out (Marzinotto *et al.*, 2010). Instead, the debated article should be best interpreted as a *no-co-responsibility* act, and not as a no-assistance act. As such, it should definitely not prevent the Community from the provision of assistance in case of mutual interest. They also claim that before the crisis, it was a widely shared view that only countries with national currencies could have difficulties with regard to their external position in general and to their current account balance in particular. Based on Article 143 (1) of TFEU, access to EU funds (and bail-out) can be provided only for countries with a derogation.⁹ The authors argued, however, that EMU countries should also gain access to financial assistance in the same form.

In fact, the proposal of the *Bruegel Institute* soon became a reality, when Greece was granted a loan worth €110 billion in 2010. However, the bail-out package was supplied not on the basis of Article 143 (1). Instead, the package was put together as a result of Article 122 (2), which enables member states to provide loans in times of extraordinary circumstances. Accordingly, member states deemed the Greek situation an exceptional disaster beyond the control of the country in question.¹⁰

The rescue package of the EU and the IMF for Greece, however, did not calm the nerves of international investors. Instead, it became painfully evident that the EU was

7 The EU15's real long-term interest rate more than halved between 1992, the start of the Maastricht process, and 2007, the last year before the crisis. One of the greatest beneficiaries was Greece, where the rate declined from 8.1 per cent to 0.9 per cent in the given period.

8 The analogy with the prisoner's dilemma is justified, since the defection from the Pareto optimal cooperative behavior was beneficial from the perspective of the *individual* member state, which could rely on cheap money and maximize its consumption – at least in the short run.

9 'Where a Member State with a derogation [i.e., a non euro-zone country of the EU] is in difficulties or is seriously threatened with difficulties as regards its balance of payments either as a result of an overall disequilibrium in its balance of payments, or as a result of the type of currency at its disposal, and where such difficulties are liable in particular to jeopardize the functioning of the internal market or the implementation of the commercial policy, the Commission shall immediately investigate the position of the State in question...' TFEU, Article 143 (1). Based on this article, Hungary, Latvia and Romania received substantial financial rescue in the heydays of the crisis of 2008 and 2009 from the EU.

10 Council regulation (96/06/2010)

not yet ready (and willing) to tackle the problems at their roots, i.e., to redesign European economic governance in a transparent, accountable and effective way. In turn, investors dramatically reduced their financial exposure to countries at the periphery. The Greek downgrading was followed by the loss of preferred investment status in both Spain and Portugal just weeks after the 110 billion Greek package was decided upon. It was high time for Europeans to replace *ad hoc*, bilateral loans-based crisis management with a more systematic and deliberate approach.

On 9 May 2010, economic and finance ministers agreed on creating a three-pillar rescue mechanism for countries in trouble worth €750 billion (ECOFIN, 2010). The European Financial Stability Mechanism (EFSM), together with the European Financial Stability Facility (EFSF) represented the bulk of the sources (€500 billion), which was supplemented by the IMF's €250 billion financial assistance. One year later, financial assistance (in both direct and indirect forms) was increased to €1000 billion. Ireland and Portugal have received bail-out via this institutional setup already.

The new European financial construction was placed under immediate fire. In a SWOT analysis, Kapoor (2010) argued that the mechanism was overcomplicated and took too much time for member states to gain access to the pool. Additionally, the European bail-out construction required originally a unanimous decision of all euro-zone countries. The Irish case also demonstrated that the bail-out mechanism could be too expensive for the country in trouble. The high interest payments can cause serious concern and the country may end up in a vicious circle by pushing it to an unintended default. It has not been clarified either whether the bond issuance of the EFSF can contribute to crowding out on national debt financing.

In its original form, it was not clear either what would happen if a large EU country applied for loans from the EFSF. The liquidity problems of a small country could be solved by injecting extra funding, but such a step would not be enough to bail out either Spain or Italy. By the end of 2010, Spain had a share of 8.1% of the total euro-zone debt, while Italy was responsible for almost one-quarter, 23.4% (European Commission, 2011).

Furthermore, from its conception, i.e., from May 2010, the financial construction has been considered as temporary, since financial assistance on a permanent basis was regarded as a violation of the words and spirit of the Lisbon Treaty (its no-bail-out clause in particular). Accordingly, the Council regulation that created the EFSF demonstratively defined its mandate in 3 years only. Its temporariness was meant to support the idea that the new financial stability facility was going to fix liquidity problems exclusively and would not be used in case of insolvency. The temporary nature did not simply serve the needs of the Treaty (i.e., respect of the no-bail-out clause); it was also governed by a strong political rationality. While managing a liquidity crisis should not necessarily mean risking tax payers' money, a solvency crisis would definitely do so.

4. The denial of default¹¹

Although the new financial construction has been purposefully established only on a temporary basis, its significance cannot be underplayed. It has triggered fundamental changes in the economic governance structure of the EU. Prior to the current financial and economic crisis, there was no single institution or mechanism which could have supported crisis management. At the time of establishing the EMU, member states forgot to declare what should be done in case of a sovereign debt crisis. In fact, a sovereign crisis was deemed as impossible. In this sense, the 'no default' pillar of the impossible trinity of denial was part of a more fundamental consensus amongst member states. It was firmly believed that the deepening of economic integration should be based on commonly shared values and the idea of an ever closer union, where solidarity and reciprocity are more fundamental concerns than pure economic rationality. A default, therefore, was out of the question, and as a consequence, there was no need to work out its institutional and procedural elements.

The global crisis, however, confronted the EU with the harsh reality of opportunistic behavior, which can push a country easily into default. A default, however, is always costly. If it were not, no one would be willing to repay the loan taken out earlier. The most typical costs come with accelerated interest rate premia, or, at its extreme, with the total drying up of market-based external financing. The bankrupt state may be threatened by some other (economic and/or political) sanctions as well, unless the denial of payment comes as a result of an external shock (Grossmann and Van Huyck, 1988). Rose (2005) also underlines the substantial negative effects of defaults with regard to international trade.

Gianviti *et al.*, (2010) distinguish three levels of uncertainty in the EU in times of sovereign debt crises: (1) the willingness and ability of the troubled member state to meet all its liabilities without reservations, (2) the reaction of creditors, and (3) the behavior of other member states, the Community as a whole and the ECB – their willingness to rescue the debtor country.

As far as the first level is concerned, willingness of the member state to meet its obligations is eventually a political question. If incumbents are afraid of a strong social opposition to consolidation efforts, they may decide to renege on the country's

11 The term 'default' can be applied (in relation) to states only with some reservations. States cannot go bankrupt in the same way as financial and non-financial companies do (i.e., assets deteriorate so that liabilities cannot be met in full). It is better to claim instead that default occurs only if the borrower country is not *willing* (or is not *capable*) to pay to its lenders. Practically, default happens if the budgetary consolidation would be so expensive in political terms that incumbents would not be willing to take the risk of budgetary adjustments. It is more correct to use the terms *debt rescheduling* or *debt restructuring* in relation to sovereigns' default. In the former case, the present value of the future payment liabilities is reduced, whereas in the latter case only the lending conditions change (i.e., maturity, interest rate, etc.), and the present value of liabilities remains intact.

debt liabilities. While such a decision may provide some room for the government in trouble in the short term, it certainly causes frustration amongst creditors and may deteriorate the long-term development prospects of the country for good. On the second level, uncertainty evolves on two different fronts. First, it is not clear whether other creditors are ready to wait for the troubled country to sort out its problems, or panic-stricken investors try to get rid of their devaluating bond securities, converting a liquidity crisis into a solvency one. Second, it is absolutely unknown *ex ante* how creditors would react to an announcement of default. Would they be able to work out a consolidation plan together with the government? Or would a minority of bondholders try to block agreement in order to cash out on the default? Prior to the 1990s, it was relatively easier to work out a debt restructuring plan because it was either the sovereigns (Paris club) or the major investment banks (London club) which financed sovereign debts. In the current situation, however, the initiation of debt restructuring is more problematic, due to the extremely large number of creditors.

The very nature of the euro-zone provides, however, a third, new level of ambiguity, too. Neither the troubled nation, nor other member states (along with international investors) can be sure if political solidarity (i.e., bail-out) or sticking to the words of the Lisbon Treaty (prohibition of a bail-out) would have the upper hand in the game. Ambiguity is further strengthened by the fact that decisions are made by the European Council, an intergovernmental organization. This body makes decisions in a series of political bargains; therefore, it is impossible to predict any outcome *a priori*.

It did not come as a surprise, therefore, that following the spring 2010 decision on the €110 billion Greek rescue plan, it took another 6 months for European leaders to admit that an orderly default procedure should be an inevitable part of Europe's redesigned economic governance structure. Otherwise, troubled nations should find solutions to their mounting problems in the form of unchartered disorderly defaults. As a corollary, on 17 December 2010, heads of states and governments agreed on the establishing of a permanent crisis mechanism. The official reason was to strengthen the economic pillar of the euro-zone (European Council, 2010), whereas the harsh reality was simply the inability of troubled nations to find private investors to renew their matured debt securities.

The new permanent crisis mechanism, the European Stability Mechanism, will assume the role of the previous two funds, i.e., the EFSM and the EFSF, and it will function as the main source of external financing for countries in the euro-zone. The ESM will rely basically on the same instruments as its predecessors, such as primary market purchases, interventions in secondary markets, loans to member states and recapitalization of financial institutions. Its capacity to lend will be reviewed on a regular basis in order to provide ample resources to prevent a crisis (Treaty on ESM, 2012).

With the creation of the ESM, European policy-makers have undeniably admitted that the earlier triple denial of exit, bail-out and default was impossible to sustain any longer. Since exit is not a real and welcomed option, the other two denials (no bail-out and no default) should be compromised in order to find solid and robust solutions to

the EU's debt crisis. Nevertheless, heads of states and governments also agreed that the provision of official financial assistance had to be in line with the current European legislation, and, in particular, it could not violate Article 125 of the Lisbon Treaty by any means (European Council, 2011a). As a consequence, the permanent mechanism is to be placed into operation only if the stability of the *whole* euro-zone is endangered (that is, contagion is a real threat). Additionally, the permanent crisis mechanism should not endorse any further moral hazard, a phenomenon which has already seriously damaged and undermined the credibility of the whole system. Prior to the start of the EMU project, one of the strongest arguments against a permanent mechanism was exactly the fear that countries would have borrowed more than without it. Interest rate convergence made external financing relatively cheaper for most countries, which proved to be a strong motivation for overspending in Greece for instance.

The new mechanism should conform to two major roles: (1) assist the troubled sovereign, and (2) deter countries from applying for community assistance. The question is, therefore, how an orderly default mechanism can be a sufficient deterrent. The ESM will provide external financial assistance only if the country in need meets two strict conditions: (i) a rigorous debt sustainability analysis conducted by a panel of independent experts, and (ii) the application of a robust consolidation program. The former condition is required in order to clarify whether the country was hit by a liquidity or a solvency crisis (European Council, 2011a).¹² The sustainability analysis will also have a crucial role in determining what role the private sector should take in stabilizing the debtor. If a country turns out to be solvent (that is, by adopting a credible adjustment plan, the country can stabilize its debt record on a sustainable level), private investors are encouraged to take the lead role in financing the debtor.¹³

If, however, the analyses reveal that the troubled nation suffers from a solvency crisis, that is, no budgetary consolidation effort can put the economy back onto a sustainable path, the member state is obliged to start negotiations with its private creditors. Stakeholders should work out together a credible debt restructuring plan with the aim of restoring sustainability in the realm of public finances. That is, the country is officially allowed to call on a(n orderly) default.¹⁴ In principle, the instituti-

12 In contrast to financial and non-financial corporations, however, it is not always easy to draw the line between a liquidity crisis and a solvency crisis. Even if a country is solvent *ex ante*, liquidity tensions can induce insolvency.

13 This approach was first used in Central and Eastern Europe by the IMF and the EU in 2009. The so-called Vienna Initiative prohibited foreign banks from withdrawing capital on such a large scale that would have caused the collapse of CEE financial markets. Due to the Initiative, the region avoided a solvency crisis which could have been triggered by the otherwise bankrupted banking sector.

14 Although the EU jargon is very cautious in using the term 'default', it has admitted the importance of private sector involvement (PSI) with regard to the Greek crisis as early as the summer of 2011. The Greek government was expected to reach an agreement with private investors on a voluntary bond exchange, equaling 50% of the debt held by privates. The PSI

onalization of a sovereign debt resolution, along with a strict adjustment plan, should reduce uncertainty on every level (i.e., uncertainty on the level of the debtor state, the creditors and the EU – see Giavanti (2010) above).

With the launch of the ESM, the European Council has made its intentions clear in an almost decade-long debate on the design of crisis resolution.¹⁵ It was not that long ago that the IMF proposed a mandatory and highly centralized construction under the auspices of an international debt restructuring agency, as a response to emerging market crises (see Krueger, 2002). The plan failed mostly because of the fear of delegating too much power into the hands of the IMF and of downplaying the essential role of market incentives. It was not the EU's intention to revive this idea, either; instead, it has propagated a more decentralized, market-focused solution. Nowadays it is the stakeholders who have to come to an agreement on the details of a default. In practice, every new debt issuance should contain a so-called *collective action clause* in the future. Terms and conditions will be standardized throughout the euro-zone. Creditors will have the right to start negotiations on debt restructuring based on a qualified majority of bondholders.

One of the main arguments for a decentralized orderly default has been that with the threat of a potential haircut (or any other types of debt restructuring, such as longer maturity), investors would be much more cautious in their financial decisions in the future. The stricter financial market monitoring will make it practically impossible for undisciplined sovereigns to access external financing in case of unsustainable public finances. Nevertheless, the approach chosen by the EU has its weaknesses, too. On the one side, the new construction wants the creditors to be more active in monitoring and more cautious in investment decisions. In turn, the sovereigns' debt market can be stabilized (by not allowing any country to accumulate non-financeable debt levels). On the other side, the new mechanism expects the same creditors to take out their own shares of burden in case of a default. As a consequence, rational bondholders will have no other choice than to get rid of their risky (and predictably devaluating) assets. The wish to minimize losses will, however, destabilize the market eventually. According to De Grauwe (2011a), it is exactly this paradox which has made it previously impossible to put an orderly default mechanism on a global scale into effect.

also called for an ambitious and credible adjustment program. On 12 March 2012, the Greek government announced a successful bond exchange worth of €177.25bn. The agreement between the government and private bondholders was one of the conditions for the second Greek rescue package, amounting to €130bn (Council of the European Union, 2012)

15 The intergovernmental Treaty on ESM (2012) itself was signed first on 11 July 2011. Half a year later (23 January 2012), the economic and finance ministers initiated modifications in order to improve the efficiency of the ESM (incorporating all relevant decisions made previously, especially the ones of 9 December, making it possible to act on the basis of a qualified majority in case of an emergency). The new treaty was signed on 2 February 2012 and parties agreed on 1 July as the date for the treaty to enter into force.

5. Squaring the triangle

It has never been the ambition of the European Union to become a federal state such as the US or India. Nevertheless, throughout the past few decades, the EU has developed into a complex, multi-layered organization with unique institutional and decision-making structures. Its critics have always underlined that without a common budget of the size of federal states, the euro-zone would never be able to qualify for a well-functioning and stable monetary zone.¹⁶ The current crisis seems to provide evidence for such a claim.

Yet, the fact that the EU was able to earn substantial credit in the nineties and early 2000s was mainly thanks to its single currency. The EMU project did revitalize the European integration process and the euro was considered as a huge success from the very beginning of its birth (European Commission, 2008). The euro became the symbol of how countries can *voluntarily* withdraw a part of their national authority and delegate it to a supranational level, without fully giving up their sovereignty.¹⁷ The godfathers of the single currency firmly believed that the euro was indeed a quantum leap towards an ever closer union. In fact, the single currency was best interpreted as a litmus test for a political union in the distant future. It was only in the autumn of 2008, the time when the waves of the 2007 US-born economic and financial crisis reached Europe as well, that proponents of the single currency had to admit that the EMU has fallen short on economic governance.

The decision on adopting the single currency was indeed a vital step on the road towards an 'ever closer Union'. The key to the current puzzle, posed by the impossible trinity of denial, however, may not necessarily contribute to a further deepening of European integration. Whereas professionals on both sides of the Atlantic demand a more inclusive and supranational response to the current challenges, European politicians seem to choose another direction, i.e., a more active reliance on intergovernmental practices. The most recent meetings of heads of states and governments in late 2011 and early 2012 (European Council, 2011b, 2012) seem to verify this point.¹⁸ The new Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG) is for instance a pure manifestation of intergovernmental policy coordination.¹⁹

16 These concerns have been formulated mostly by US scholars, both conservatives such as Martin Feldstein (1997), and liberals like Paul Krugman (2009).

17 It would be highly misleading, however, to date the origin of a close monetary integration to the birth of the EMU or the single currency itself. The German currency worked as an anchor for many years before the launch of the euro; that is, *de facto* monetary independence of member states did not exist at all (Csaba, 2012).

18 This article was finalized in April 2012.

19 Although the TSCG aims at becoming an indispensable part of the treaties of the Union sooner or later, it is, in its current format, an intergovernmental agreement (treaty) of the participating countries only. What makes its strong position and influence unprecedented is that any financial assistance of the ESM will be strictly conditional upon the national ratification of the TSCG (see Treaty..., 2012).

Needless to say, strengthened intergovernmental decision-making always reflects some sort of political consensus; thus, it can have some merit. Yet, decisions in intergovernmental bodies such as the European Council or the ECOFIN are the end-result of a long and non-transparent bargaining process, where political rationality often prevails over an economic one. It is highly questionable, therefore, whether markets would really give credit to the ESM if its decision-making mechanism is not transparent and automatic enough. In fact, one of the main reasons for the current paralysis of the European economic governance structure and mechanisms is exactly the slow, ambiguous and discredited political decision-making process.

In sharp contrast to the active involvement of the European Council, neither the European Commission, nor the ECB have had any decisive role (yet) in either the Greek rescue process or the reform of European economic governance. It has been the European Council (or to put it more clearly, the decisions of the *euro-zone* heads of state and government) which has dictated the pace and the direction of crisis management. Even the proposed structure of the ESM reflects an intergovernmentalist mentality. The governing body of the ESM will comprise of the economy and finance ministers – exactly the same body which was responsible mostly for damaging the original Stability and Growth Pact.²⁰ In its original version, members of the Board of Governors of the ESM should have agreed unanimously on the most important issues, such as (1) the provision of financial support, (2) the terms and conditions, or (3) any change in instruments which would have made it practically impossible to react swiftly and with the proper measures. But even in its renewed form, an incredibly strong, 85% qualified majority is required to initiate the necessary steps in case of emergency (Treaty on ESM, 2012).

One of the most evident experiences of the last couple of years was that without a qualified majority and some sort of automatism, decision-making would degenerate into a time-consuming and politically biased process, undermining the credibility and efficiency of any stabilization effort. One possible solution would be the strengthening of supranational institutions, which are assumed to be deaf to national goals and pursue the interest of the Community. Both the European Commission and the European Central Bank have the capacity and ability to monitor and evaluate the performance of the individual member states and the Community as a whole. Furthermore, these two supranational institutions would be able to make swift and effective decisions in case of an emergency.²¹

The political leaders of member states have explicitly neglected the European Commission in the last couple of years. Wyplosz (2012) argued that the Commission

20 See Crawford (2007) or Eichengreen (2012) on how the Pact was made ineffective by shortsighted governments.

21 Only recently has the TSCG given more power to the Commission by admitting that the institution does indeed have the capacity and skills to evaluate the economic conditions of member states and the fulfillment of austerity programs.

itself could be blamed for its negligence, too, due to President Barroso's reluctance to play a more ambitious role in crisis management and thereby leave it to heavy-weight politicians to take the required measures. The situation has been, however, quite different with regard to the European Central Bank. Politicians definitely wished to see a more active and accommodative ECB during the crisis.

It has been noticed long ago in the scholarly works of political economy that rational politicians are reluctant to delegate authority over issues which can redistribute rents to their constituencies (see for instance Drazen, 2000). Since direct access to distributional resources makes the government capable of organizing a winning coalition in election times, no rational incumbent has the incentive to weaken its own sovereignty. Alesina and Tabellini (2007) have demonstrated that politicians delegate only those tasks to bureaucrats and (supranational) institutions which require technical knowledge on the hand and provide little direct benefit to incumbents on the other hand. Monetary policy has become an ideal policy area for delegation, since it assumes special skills and it is difficult to communicate its direct benefits. The situation is rather different, however, with regard to fiscal policy: both taxation and spending can provide ample room for politically motivated actions, which are easy to target and communicate. In the context of the EU, while European politicians agreed on the establishing of an independent central bank, they have remained very reluctant to give up national authority over fiscal policy. Member states have not shown too much interest in authorizing the Commission to act on behalf of member states in times of an economic crisis, either. Heads of states and governments have anxiously tried to keep their hands on every single detail of crisis management, thereby reflecting a strong inclination toward intergovernmentalism.

Since the ECB is the sole independent supranational body of the euro-zone, it is logical to ask what it can do or what it should have done in the context of crisis management. In principle, countries with their own national currencies can easily rely on the support of their central banks. No such institution is, however, available in a monetary union; the responsibility of a central bank, therefore, increases substantially. The Lisbon Treaty defines the mandate of the ECB clearly, by enforcing it to guarantee price stability. Only if this objective is not in jeopardy can the ECB support the general economic policies of the EU (Article 127 TFEU). As opposed to the Fed, therefore, the ECB cannot act as a lender of last resort on behalf of sovereigns. The rationale of creating a monetary authority with such a narrow mandate and focus (i.e., price stability) was straightforward, however: to avoid moral hazard in a community of many different countries and preferences.²²

Although the ECB is unwilling to act as a lender of last resort, it has been rather keen on accommodating the liquidity needs of the troubled banking sector.²³ De Gra-

22 The TFEU explicitly prohibits the monetization of sovereign debt (Article 123 (1)).

23 The ECB has provided substantial rescue for banks from 2008 onwards. Financial institutions could finance themselves by cheap credit via the regular refinancing mechanisms well

uwe (2011b) argued for instance that rational central bankers may simply attach different weights to the costs and benefits of bailing out banks or sovereigns. Whereas a banking crisis can trigger an immediate collapse of the whole financial sector, no such quick spill-over can evolve in case of a sovereign crisis. Since a possible collapse evolves over a much longer time (if at all) in the latter case, central bankers attach less weight to the benefit of a bail-out of sovereigns and prefer to choose a wait-and-see option.

It is rather doubtful whether the late 2011 change in the behavior of the ECB, i.e., the introduction of the long-term refinancing operation (LTRO), should be interpreted as a result of reweighing the benefits and costs of intervention. It is more likely that the renewed Stability and Growth Pact, along with the new fiscal compact of a decentralized system of fiscal rules, made it easier and more convenient for the ECB to engage in non-conventional methods. With its indirect support of the sovereign debt markets, the ECB is still in line with the Lisbon Treaty, and it has avoided the reinforcement of moral hazard across the euro-zone. Its liquidity pump has provided additional time for countries at the periphery to do their homework.

Applying the conceptual framework of this article, it can be argued that the re-design of the economic governance of the Economic and Monetary Union is a clear admission to the fact that the original structure of the euro-zone was not feasible. The current crisis compelled Europeans to admit that the implicit consent of Maastricht on the triple denial of (1) exit, (2) bail-out, and (3) default is no longer tenable. Since exit has never been a welcome option, the official response of the EU to the impossible trinity of denial has been the establishment of the European Stability Mechanism, which allows countries to apply for financial rescue, and which also supports partial orderly default in extreme cases. That is, the EU seems to be ready to ease on its earlier position with regard to both the bail-out and the default options. The price of financial solidarity is, however, rather substantial. Troubled nations have to undertake severe consolidation efforts not only in their public finances but also in the supply side of their economies. European policymakers wanted the cost of financial support to be high enough to deter countries from further future fiscal indiscipline.

The newly created ESM, the renewed Stability and Growth Pact, along with the Treaty on Stability, Coordination and Governance in the EMU, has changed the rule book of the EU and the monetary zone in particular substantially. More importantly, all these inventions have made the ECB more comfortable in credibly demonstrating to financial markets its readiness to safeguard the stability of the whole euro-zone in case of an emergency. Certainly, in the environment of multiple equilibria, the step-in

below market rates. Additionally, so-called emergency liquidity assistance was provided at a relatively cheap price. In May 2010, the ECB launched its securities markets program, which was defined as an *ultima ratio* (ECB 2010a).

of the ECB may just prolong a (future) disaster and not fix the problem itself. While the ECB cannot still be considered as a lender of last resort of the sovereigns, and the E(M)U itself is very far from a fiscal union, these developments can be considered as the right steps in the direction of rescuing the single currency.

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