THE EURO ZONE – BETWEEN FISCAL HETEROGENEITY AND MONETARY UNITY

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Abstract

In a period in which the functioning of the Euro Zone has generated intense debate, this paper aims at providing a detailed view on one of the main characteristics defining the single currency area: the dichotomy between a unique monetary policy and an almost complete lack of fiscal integration. After analyzing the relationship between fiscal and monetary policies, we identify within the European construction a series of weak points generated by a highly heterogeneous fiscal environment, arguing that these deficiencies need to be swiftly addressed. Last but not least, we set forth potential solutions that would promote Euro Zone fiscal discipline and would help eliminate asymmetric shocks, thus creating a more uniform economic environment in which Member States enjoy an increased financial health and in which monetary policy can be more efficiently conducted.

Keywords: Euro Zone, fiscal policy, monetary policy, fiscal discipline.

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1. Introduction: general considerations on fiscal and monetary policies

Today's macroeconomic context is more complex than ever, as ever stronger global interconnections create waves of external factors that influence local economies, thus putting pressure on domestic policy to mitigate unwanted effects and regulate the economic environment in the direction of achieving desired macroeconomic objectives regarding inflation, unemployment, consumption, investment or expenditure levels. Such objectives are however influenced by two completely different sets of instruments, controlled by two completely different authorities. The first such set is of a fiscal nature and, in democratic states, which are the focus of our study, falls within the responsibility of people elected bodies, be them of an executive or legislative essence. The second set that holds great power in influencing economic variables belongs to the monetary area and is controlled by an independent central bank (even if some basic level of accountability to political bodies still exists). This dual situation may be the source of great synergies that come from an efficient combination of the two sets of instruments, but it can also prove to be negatively influenced by what can sometimes be a hard to manage relationship between political bodies and an independent central bank. This paper is aimed at exploring this duality in the case of the Euro Zone and at analyzing how a climate characterized by the existence of a unique monetary policy and an extremely low fiscal integration affects Euro Zone structural efficiency. But before plunging deeper into the analysis, let us briefly take a look at the main characteristics of each type of policy in general, fiscal and monetary.

Blanchard (2006, p. G-4) defines fiscal policy as a government's choice with regard to taxes and expenses, while Weil (2007) provides more details by adding that fiscal policy is composed of the government's decisions concerning the goods and services that are being purchased, the transfer payments made and the taxes collected. All these directly affect the tax payers' available capital and the demand for goods and services, and thus ultimately induce effects on the production level, the unemployment rate and inflation. Basically, through fiscal policy the government manages a country's processes, so that it reaches desirable effects from a social and economic perspective. In order to achieve these objectives, governments make use of two types of fiscal instruments, the first category linked to government spending (i.e., investments in infrastructure, education, health care, social transfers), and the second to government revenues. The revenue related fiscal instruments include the government's practices regarding taxes and user charges, the latter meaning individual payments for services provided by the government (Hagemann, 2012). However, a particularity of fiscal policy lays is the fact that its two categories of instruments are in an inverse relationship with each other, more precisely that the effects of the revenue based fiscal instruments are conditioning the use of spending based instruments. Of course, intertemporal transfers of funds (i.e., government borrowing or lending generated by a deficit or a surplus in the budget) will alter this equation, but the nature of the relationship still holds. This puts fiscal policy making in the unique position of having to balance these two antagonist types of instruments and of combining them with administrative and management skills that allow for greater efficiency in spending, on one side, and a non-disruptive influence of taxation and user charges, on the other.

We will now turn our attention towards elements concerning monetary policy, which has a completely different structure than fiscal policy, but casts an important, often decisive, influence on many of the economic variables that are fiscally targeted by government bodies. According to Labonte and Makinen (2006), monetary policy is made up of the directives, policies, pronouncements and actions of the central bank that affect aggregate demand or national spending. Taylor (1995) identifies the main goals of monetary policy as referring to controlling the real values of the gross domestic product and of the inflation level, while Cecchetti (2000) takes a slightly different perspective by considering that monetary policy objectives are focused on the stabilization of the levels of production and inflation. However, the way in which monetary policy is being conducted, its objectives, and the instruments used to secure them have always been a topic of debate between economists and their different economic philosophies. In this sense, the words of Milton Friedman (1968) are emblematic:

> *'There is wide agreement about the major goals of economic policy: high employment, stable prices, and rapid growth. There is less agreement that these goals are mutually compatible or, among those who regard them as incompatible, about the terms at which they can and should be substituted for one another. There is least agreement about the role that various instruments of policy can and should play in achieving the several goals.'*

Central banks conduct monetary policy by exerting control on interest rates. Their main instruments focus on influencing the supply and demand for money and on setting interest rate benchmarks, i.e. unilaterally deciding how much they charge or pay credit institutions for borrowing or lending money from/to the central bank. All these actions alter directly only short term interest rates, but their effects are then being propagated through the interest rate and credit channels of the monetary policy transmission mechanism, eventually influencing long term interest rates and credit market conditions, which are crucial for the way in which the economy operates. Evidently, this also casts a strong effect on the financing cost of the public sector, and thus influences fiscal policy.

In addition to these traditional monetary instruments, the monetary practice from previous years has added another class of instruments, generically called quantitative easing, to the arsenal of central banks. According to Blinder (2010, p. 1), quantitative easing measures are used to bring 'changes in the composition and/or size of the central bank's balance sheet that are designed to ease liquidity and/or credit conditions'. Such instruments imply a direct participation of the central bank in the economy by creating new money, thus being considered by monetarists and market libertarians a breach of capitalist rules. Quantitative easing is used when other monetary measures have already been exhausted, more precisely when inflation and investment levels are low even in a zero (or almost zero) interest rate environment. As Roubini and Mihm (2010, pp. 260-261) notice, by adopting such measures, central banks shift away from their traditional role of lender of last resort to a not so long ago unconceivable role of investor of last resort – a somewhat fiscal attribute!

Fiscal and monetary policies represent two entirely different sets of powerful instruments that are responsible not only for modeling the macroeconomic environment, but also influence each other. In such a climate, which is characterized by simultaneous pressures from these two extremely different forces, we can define a fiscal – monetary dichotomy that characterizes economic development and which can either lead to an effective and efficient result or, on the contrary, can provide the premises for a confusing and uncorrelated set of decisions that generate a suboptimal outcome.

2. The fiscal – monetary dichotomy in the Euro Zone

The European Union is perhaps one of the most ambitious political and economical projects ever designed, as it brings under the same governance a continent that is historically heterogeneous, both culturally and politically, in an attempt to find, as its slogan so skillfully describes, unity through diversity. In this context, the creation of the single currency area is, without any doubt, one of the major accomplishments of the European project. However, there are still some unresolved issues, as the benefits of such a monetary arrangement, which according to Krugman (2012) take the form of reduced transaction costs, the annulment of the exchange rate risk, greater transparency and a potential growth in competitiveness due to the fact that prices are easier to compare, are weighted by fiscal heterogeneity. The fact that the Euro Zone exists and functions with a certain degree of effectiveness does not mean that the monetary union is complete in every sense, as there are certain elements that question the efficiency of the system in its current state of development and call for further actions that would strengthen the economic environment. The challenges are however enormous, as sovereignty is something that national states are seldom willing to give up, nor should they be, at least not under any conditions.

After more than six years of economic crisis, the creation of the monetary union is now, maybe more than ever, a controversial issue, the pro and con arguments fueling debates both at the level of the Member States who already adopted or pledged to adopt the Euro and in those who rejected the adoption of the single currency[1]. At the center of these debates stands the duality between fiscal and monetary governance.

Normally, the fiscal – monetary dichotomy arises because, on the one hand, monetary policy is controlled by an, at least partially, politically independent central bank, while fiscal policy decisions are taken by institutions of a political nature which are directly accountable to their voters and thus vulnerable to social pressures, with the advantages and disadvantages that this direct link to the people provides. Main such advantages regard the increased accountability of government bodies, but sometimes politicians may fail in correctly evaluating the disadvantages arising

1 Great Britain, Sweden and Denmark, even though the latter has pegged its currency to the Euro.

from popular pressures to shift from a long term oriented strategy to one that favors the short term.

The fiscal – monetary relationship is a bilateral one and, as practice from so many countries has suggested, can normally be managed by the involved institutions so that it generates effective and efficient economic outcomes. However, in the Euro Zone, the fiscal – monetary dichotomy exists under substantially different conditions, as a unique monetary policy interacts with eighteen different fiscal policies carried out by each of the national governments of Euro Zone Member States. It is no longer a bilateral relationship, but a multilateral one, as on the one hand, monetary policy prerogatives are set centrally within the control of the European Central Bank (ECB), whose decision making process takes into consideration the interests of the Euro Zone as a whole and pays little attention to the individual needs of each of its Members, and on the other hand, the fiscal policy approach allows each of the eighteen Member States to devise its own fiscal strategy, focusing, unlike the ECB, strictly on the national interest. According to Kennen (1969), the issue regarding potential peripheral inefficiencies generated by a unique centrally coordinated monetary policy may be addressed, at least partially, through fiscal policy decisions that would compensate for the lack of monetary policy efficiency. However, this compensation will seldom be complete, as the potential efficiency of fiscal measures in influencing macroeconomic variables is much weaker than that of the adequate monetary policy actions (Cecchetti, 2000).

Let us now take a look at the Euro Zone's currency union – fiscal autonomy arrangement from a different angle. The most influential research on the subject of the common currency areas is provided by Mundell's 1961 Optimal Currency Area Theory, which represents the theoretical core of the Euro Zone. As Mundell (1961, pp. 660-661) notes, 'the optimum currency area is the region' and 'if regions cut across national boundaries or if countries are multiregional then the argument for flexible exchange rates is only valid if currencies are reorganized on a regional basis'. He then adds that

> *'if the world can be divided into regions within each of which there is factor mobility and between which there is factor immobility, then each of these regions should have a separate currency which fluctuates relative to all other currencies. This carries the argument for flexible exchange rates to its logical conclusion. [...] But if labour and capital are insufficiently mobile within a country then flexibility of the external price of the national currency cannot be expected to perform the stabilization function attributed to it, and one could expect varying rates of unemployment or inflation in the different regions'* (Mundell, 1961, pp. 663-664).

As we can see, in his quest for currency area optimization, Mundell is mostly interested in the free flow of capital and labor, components which are indispensable for a fully functional common currency area. But which are the structural elements influencing labor and capital mobility? We will argue that there are two elements that need to simultaneously exhibit a favorable status for factor mobility to exist and that they are primarily linked to legislation and cultural barriers. If the former has been clearly addressed by the EU treaties by setting down common rules that eliminate legal obstacles[2], the latter represents the result of centuries of historical evolution and cannot be so easily tackled, as European nations have developed individually and have often been in tensed relationships with one another, thus making national identity a much less abstract notion than a common European identity. In this context, the main cultural barriers, such as historical disputes and the multilateral resentments they generated, consistent linguistic differences, different national symbols and values, differences in cultural traits as defined by Hofstede (2011) and attitudes towards immigrants, represent obstacles in the way of European integration (Dan, 2013) and, more specifically, labor mobility. This is consistent with the findings of European Commission scholars Gáková and Dijkstra (2008, p. 2), who show that more than 85% of the European Union's internal labor mobility is represented by movements between the regions of the same country. Focusing on the EU – 15 Member States[3], Holland and Paluchowski (2013) find that, in 2010, cross-border labor mobility in this region (which includes 12 of the 18 Euro Zone members) represented just 0.35 % of the total labor force, highlighting the big difference to the 2.4% inter-state labor migration in the United States.

Looking at the supply vs. demand for labor, we find great differences between Euro Zone Member States, as October 2013 unemployment levels range from relatively low levels of 4.8% in Austria and 5.2% in Germany to staggering 26.7% in Spain and 27.3% in Greece[4], with a Euro Zone average of 12.1%, according to Eurostat. In an environment of increased labor mobility, these differences would tend to level out, as idle workforce from high unemployment countries would migrate to low unemployment ones, where work would be easier to find, even if this would mean driving down wages. This is, however, not the case of the Euro Zone.

Consequently, even if it is hard to objectively determine which is the sufficient level of labor mobility so that the Euro Zone may function efficiently, we adhere to the conclusion of Gáková and Dijkstra (2008, p. 2), who concede that 'labor mobility does not play an important role in reducing the disparities between EU regions, therefore other aspects need to be considered when designing policies to reduce economic and social disparities between regions'. This makes the current level of intra-Euro Zone labor mobility an element that hinders the functioning of the common currency area.

An answer to this imperfect situation transpires from the work of Kenen (1969), who studies the role of fiscal policy in the context of the optimal currency area, reaching the conclusion that fiscal unity may compensate, at least partially, the lack of labor mobility, thus adding another dimension to the Mundellian concept. Later, revisiting his 1969 ideas, Kenen (2003, p. 150) shows that fiscal policy, and more precisely its tax

2 The last restrictions set by transitional agreements for Romanian and Bulgarian nationals expired on 1st of January 2014.

3 The countries that joined the EU prior to the 2004 enlargement wave: Belgium, Denmark, Germany, Ireland, Greece, Spain, France, Italy, Luxembourg, Netherlands, Austria, Portugal, Finland, Sweden, United Kingdom.

4 August 2013 level.

component, may be used to regulate available income as a function of the production level (i.e., an increase in taxes in the area where production levels are rising and a tax decrease in the area where the production dynamics are pointing at a lower level), with relevant effects on labor demand. This view places the burden of taking actions on the shoulders of fiscal policy makers, who should include the issue of labor mobility among their priorities with the goal of aiding monetary policy in its regulatory mission. However, in a European context characterized by an accentuated fragmentation of fiscal prerogatives between national governments, it is extremely hard to believe that a relevant number of national political entities will respond to such a request.

We will next change perspective and look at the fiscal – monetary policy dichotomy from another point of view by analyzing whether an environment with increased labor and capital mobility is enough for a common currency area to function efficiently in the absence of fiscal integration, or at least a high degree of fiscal discipline. Let's just pretend that a certain Euro Zone member state is confronted, unlike the others, with high levels of public debt and budget deficit and is forced to respond to the situation with a certain type of fiscal austerity solution. This basically means that the country's biggest consumer and employer, the government, has to either severely cut back on its expenses, or rapidly increase its revenues through superior taxation, leading to weaker demand (and consequently to a GDP contraction) through one or more of the following channels: 1) a direct channel based on the inferior purchase of goods and services by the government; and/or 2) a channel based on the decreased buying power of public sector employees; and/or 3) a channel based on effects of weaker demand due to increased taxes and their impact on the disposable income of consumers; and/or 4) a channel based on the negative effects that increased taxation has on investment levels. Yet, due to the inevitable GDP contraction generated by such a course of action, austerity measures will most probably be insufficient in delivering economic redemption, in which case the classic, but still reliable solution lies within the depreciation of the national currency, thus making the debt inferior in real terms and consequently more bearable for the encumbered government. This however can never be an option for a state that is part of a common currency area, as it does not have control over monetary policy and has no ways of interfering by means of monetary policy in its currency's exchange rates.

Another issue regards the fact that, within a common currency area like the Euro Zone, lack of fiscal discipline of one state will produce undesirable effects to other states participating in the monetary union. In other words, a scenario that is very similar to the Greek situation, which was, at least in the short term, resolved by creating a temporary, unofficial and half measured common fiscal construction aimed at providing bailout funds that would keep Greece out of bankruptcy. We say that this is actually some sort of a fiscal construction due to the fact that the bailout was organized using public European money and was clearly not an investment oriented decision, but a kind of fiscal transfer (even though money is provided as credit, at least declaratory), in the conditions in which interest rates are considerably lower than the ones charged by markets and it also remains unclear whether Greece will eventually be able to return all of the borrowed sum or will get a debt cut-off, as it has gotten in the past. The fact that the sovereign debt problem was, at least temporarily, tackled within the Euro Zone and the integrity of the monetary union does not seem to be in danger any more, does not however constitute an argument in favor of the existence, or at least of the irrelevance, of the fiscal – monetary dichotomy; on the contrary, the appearance of such events signals that the contrasting European arrangements regarding fiscal and monetary governance are a source of severe inefficiencies that cannot be overcome by an increased mobility in labor and capital.

3. Fiscal discipline in the Euro Zone

As we have already showed, the Maastricht Treaty brings clear provisions regarding national fiscal parameters, i.e. the budget deficit should not be greater than 3% of the country's GDP and the government debt to GDP ratio should not be greater than 60%, provisions that have been undertaken by all, present and future, Euro Zone Member States, at least formally. The real situation looks however entirely different.

According to Eurostat data for the period between 2008 and 2012, only 1 out of 17 Euro Zone Member States[5] has fully complied with the provision regarding the 3% budget deficit limit (Latvia), while 11 out of 17 countries missed the target in at least 4 of the last 5 years, as it can be seen in Figure 1 below. Moreover, some countries, such as Ireland, Greece or Spain, have registered enormous deficit levels, the Irish staggering 30.6% budget deficit registered in 2010 being at the top of an extremely troubling list[6].

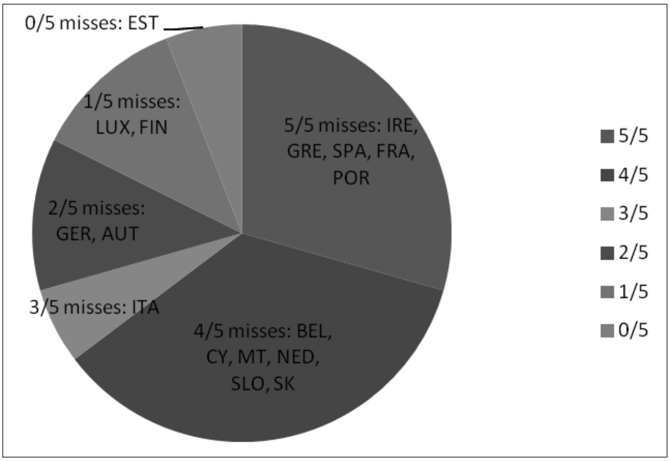

Figure 1: Number of times Maastricht Treaty yearly budget deficit provision was missed by EU Member States between 2008 and 2012

Source: Author's calculations based on Eurostat data

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5 Due to the fact that it had just joined the Euro Zone in January 1st 2014, Latvia has not been included in this analysis.

6 For a complete picture of the budget deficits registered by Euro Zone Member States between 2008 and 2012, please see Annex 1.

Things look in a similar fashion when analyzing the Euro Zone Member States' public debt levels. Again, 11 out of 17 Euro Zone members have registered surplus debt when compared to the Maastricht Treaty provisions in at least 4 out of the 5 considered years, while only 5 out of 17 countries have managed to maintain a lower than 60% debt to GDP ratio throughout the 2008-2012 period. Clearly, the complete situation of debt to GDP ratios registered by Euro Zone members, as shown in Annex 2, reveals a bleak picture.

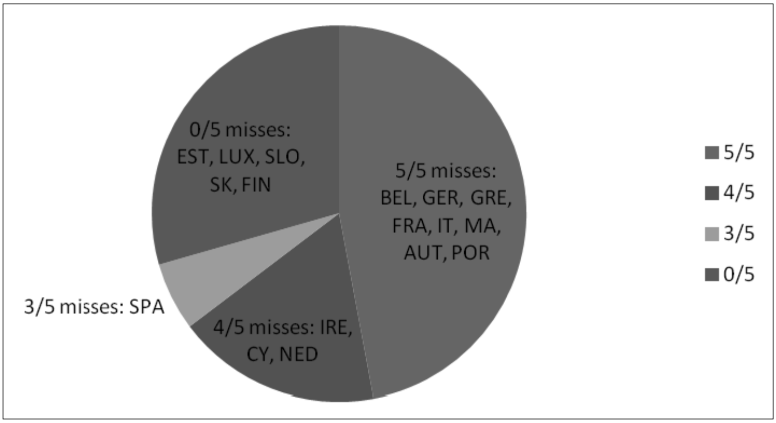

Figure 2: Number of times Maastricht Treaty yearly debt to GDP ratio provision was missed by EU Member States between 2008 and 2012

Source: Author's calculations based on Eurostat data

Moreover, in 2012, 9 out of 17 Euro Zone Members[7] registered surpluses from Maastricht Treaty provisions in both budget deficit and debt to GDP ratio. This fact, correlated with the fact that non-compliance had no administrative consequences whatsoever, leads to the obvious conclusion that the so called binding character of these fiscal requirements is, in fact, nothing more than a theoretical recommendation.

Taking our investigation deeper, we focus on the degree of heterogeneity in fiscal behavior across the Euro Zone[8]. For this purpose, we have calculated the standard deviations of the Euro Zone Member States' levels of government deficit and gross debt for each year between 2008 and 2012 and the results show quite clearly that fiscal behavior is very different across the Euro Zone and that fiscal discipline is, in practice, more of a theoretical principle.

Let us first refer to the criterion regarding the budget deficit and the actual situation concerning this requirement as detailed in Table 1. A number of facts stand out. Firstly, the standard deviations calculated for each year in the period 2008-2012

7 Belgium, Ireland, Greece, Spain, France, Cyprus, Malta, Netherlands and Portugal.

8 Due to the fact that it had just joined the Euro Zone in January 1st 2014, Latvia has not been included in this analysis.

are high (ranging from 3 to 6.8), pointing out to a very heterogeneous situation, with values as extreme as an Irish 2010 budget deficit of 30.6%. Secondly, the whole Euro Zone deficit was, in the last four years of the considered period, in excess of the 3% threshold, thus completing a somewhat desolating picture.

Table 1: General government deficit/surplus (% of GDP) across the Euro Zone

Year	Minimum value	Maximum value	Euro Zone	Mean	Standard deviation
2008	-9.8	4.4	-2.1	-2.1	3.5
2009	-15.7	-0.7	-6.4	-6.5	4.1
2010	-30.6	0.2	-6.2	-6.7	6.8
2011	-13.1	1.1	-4.2	-4.5	3.7
2012	-10.6	0.1	-3.7	-4.3	3

Source: Author's calculations based on Eurostat data

Things look very similar when it comes to the government debt to GDP ratio, as shown in Table 2 below: enormous variances between debt levels, observations as extreme as 170.3% and Euro Zone-wide indebtedness that was only in 2008 within the Maastricht limits and, additionally, has risen constantly each year.

Table 2: General government gross debt (% of GDP) across the Euro Zone

Year	Minimum value	Maximum value	Mean	Standard deviation
2008	4.5	112.9	54.9	30.3
2009	7.1	129.7	64	32.2
2010	6.7	148.3	70.2	34.9
2011	6.1	170.3	75.3	38.9
2012	9.8	156.9	81	37.6

Source: Author's calculations based on Eurostat data

In the light of all these elements, it can easily be concluded that the states which are part of the Euro Zone have very different fiscal behaviors, most of them severely lacking fiscal discipline in such a way that they somehow tacitly divert attention from the effort to actually comply with the Maastricht Criteria and instead steer it to a kind of acceptance of deviations from the maximum allowed levels as long as there are other Euro Zone Members which are in a much worse fiscal shape. The system is flawed and practice has clearly shown that in numerous cases fiscal discipline cannot be effectively enforced in early stages, but just after things have already become critical and governments, unable to finance themselves from the market any more, seek last resort help from one or more of the institutions that make up what is so plastically called the Troika (The International Monetary Fund, The European Commission and The European Central Bank). In this context, it is clear that something should be done.

4. How Euro Zone fiscal integration may actually work

Even if embarking on a journey towards a complete fiscal union and taking consistent measures in order to get closer to such an objective would strengthen the structure of the European Union and would provide economic advantages due to an increased efficiency of governance and a more uniform and, therefore, more stable and predictable business environment, it is hard to believe that such an arrangement is, at this point in the existence of the EU, possible from a political perspective. An important issue is that national governments prove reluctant to transfer towards Brussels such a big chunk of their prerogatives and therefore greatly decrease national sovereignty. Indeed, taking into consideration the profound changes that took place within the EU in the last twenty years, which led to an increased role of central institutions, correlated with economic difficulties of the past period and their effects on citizen's mentalities, it is somehow difficult to condemn this reluctance. However, measures do not necessarily need to be as decisive as implementing a full fiscal union, since certain measures of fiscal integration would dramatically improve the European economic environment while, at the same time, allowing Member States to keep most of their sovereignty attributes.

The first issue to be addressed is to effectively enforce the rules which already exist, i.e. the provisions of the Protocol on the Excessive Deficit Procedure, part of the consolidated version of the Treaty on the European Union, which clearly states that a Euro Zone Member State should not have a budget deficit (planned or actual) greater than 3% of its GDP or a ratio between its government debt and its GDP that exceeds 60%. The problem lies in the fact that, in practice, these provisions seem mandatory only for Member States seeking to adopt the Euro, and less for Member States who already use Euro as their currency, as the provisions of the Treaties (article 126) regarding fiscal discipline enforcement and the measures taken against those who are in breach of this discipline are vague and leave the final decision in the hands of the Council of the European Union[9], which, as practice showed, does not act as an effective fiscal watchdog.

The issue that arises is exactly how these provisions could be efficiently enforced, since it has been shown that the Council's supervision does not suffice.

One idea consists in automatically imposing, without the interference of the Council, financial punitive actions against Member States that are in breach of these provisions. This course of action seems however a bit rudimentary and, in some cases, could do more harm than good, as it only further impairs an already delicate financial position. Other punitive actions may target the Member State's representation rights at the EU level, imposing restrictions on voting rights within different European institutions. But such an approach also poses serious disadvantages, as it hinders democratic participation of European citizens to the decision making process, a dangerous endeavor that may produce devastating long-term effects and may prove to be a significant breach in the European construction. So perhaps solutions should not be sought in punishment and in the hope that government actions would be influenced by fear of Brussels, but in other means of avoiding fiscal discipline breach.

9 Through its Economic and Financial Affairs component.

One answer to this issue could lie in making these fiscal discipline related provisions of the Treaties mandatory by developing a clearly defined European fiscal legislation and having it implemented in national legislation via a Parliamentary vote. This way, national governments would lose legal authority to breach certain fiscal thresholds and would be bounded to respect Euro Zone fiscal discipline. However, since some cases may indeed require some degree of flexibility, temporary derogations could be granted by the European Parliament at the proposal of the Commission, a mechanism which would ensure that an overly rigid approach would not backfire in certain socio-economic contexts.

Another point of interest is related to the opportunity of issuing common Euro Zone bonds (Eurobonds). The idea is not at all new, but it received extra attention and has become more widely discussed after a paper released by the European Commission (2011) found that such instruments may bring 'significant potential benefits'. Also, Mundell (2012), one of Europe's theoretical architects, identifies the lack of Euro Zone jointly issued bonds as one of the main shortcomings of the system. In the absence of such financial instruments, there will always be significant differences in interest rates borne by Euro Zone Member States, with direct consequences on private funding also, a heterogeneity based on national criteria that leads to deficiencies in the Euro Zone monetary policy transmission mechanism due to very different sensitivities of credit to interest rates. According to De la Dehesa (2011), Eurobonds can bring key advantages, like decreasing fiscal vulnerability of Member States and thus enhancing Euro Zone stability and increasing the size, depth, liquidity and diversification of the sovereign debt market, with beneficial cost effects not only to weaker Euro Zone Member States, but eventually to financially sound Members also. Moreover, De la Dehesa argues that such European bond market would be much more attractive to investors and would provide a viable alternative to US dollar denominated debt, enabling Eurobond issuers to further benefit from increased demand.

However, as Wyplosz (2011) notices, the issue of common Euro Zone bonds could pose a serious moral hazard problem, as there is a chance that fiscally undisciplined countries would pass on the associated risks and costs to fiscally responsible ones – a great risk especially if national governments retain full decision making prerogatives with regard to their fiscal policy actions and debt to GDP ratio. In order to limit such behavior, Delpla and von Weizsäcker (2010) proposed a system that would increase fiscal discipline by allowing countries to cover debt via Eurobonds only up to 60% of their GDP and would have to obtain national financing for debt that is in excess of this level, financing that will for sure be much less conveniently priced by the market. In conclusion, they propose a similar but less restrictive solution than the one we outlined earlier, which simply implies a 60% of GDP limit to all debt, corroborated with budged deficit that does not exceed 3%.

The issuing of Eurobonds and the advantages versus disadvantages discussion regarding a more integrated European financial market is, however, just part of the picture, the other part being related to what happens with the money that is being raised. All the options taken into consideration by the European Commission (2011) imply that the money is being channeled directly towards the national budgets of co-issuing Member States, so that it covers their financing or refinancing needs. But the idea of joint debt can be taken a step further, so that financial instruments that are jointly issued by all Euro Zone members will be (at least partially) pooled in so that they constitute a common, jointly managed, Euro Zone budget. Such a budget can be used for funding different actions that would eliminate asymmetric shocks of both real and financial nature, this enhanced uniformization enabling superior financial health of Member States and the promotion of a more efficient monetary policy. Currently, there exists only an EU wide budget that is made up of contributions coming from Member States calculated according to the VAT they collect and their Gross National Income, to which are added EU custom duties and levies. This budget can be accessed by entities, public or private, from all Member States in order to finance their projects in different areas of activity. However, such a mechanism, although it represents one of the main tools of promoting general European integration, has only collateral effects on improving Euro Zone correlation between fiscal and monetary policy and eliminating asymmetric shocks. For this purpose, a parallel budget dedicated only to Euro Zone Member States could be created, but not by asking each country to make a direct financial contribution, but by issuing Eurobonds that, in some cases, should replace part of the individually issued national bonds so that the individual public debt of Member States (individual debt plus share of the common debt) does not increase above the 60% of GDP threshold stipulated in the Treaties.

5. Conclusion

In the last two and a half decades, the European Union has made remarkable progresses in designing and implementing measures for a greater European unity, both politically and economically. However, these actions mark just the beginning of a long road towards European integration and further measures and reforms need to be devised. One of the main issues that require attention is the fiscal – monetary dichotomy in the Euro Zone, i.e., the existence of a single monetary policy, promoted by a single central institution, the European Central Bank, and of numerous individual fiscal policies promoted by each national government[10], each with its own political agenda. Especially in the context of a lack of enforceable EU fiscal provisions that would ensure stability and soundness of national budgets, the relationship between the monetary and fiscal policies, both influencing the same final macroeconomic variables, is a difficult and often inefficient one. In a Euro Zone environment where, despite favorable legal provisions, mobility of labor is not ideal, especially due to cultural related issues, finding solutions for improving the fiscal – monetary relationship is crucial for an efficient functioning of the Euro Zone. We find that this situation could be addressed by bringing substantial changes to the European legislation, so that Euro Zone members will be held to respect fiscal discipline provisions, and by issuing common Eurobonds

10 When writing this article, there are 18 Euro Zone Member States.

as an effective means of financing debt while at the same time decreasing vulnerability of Member States and increasing the size, depth, liquidity and diversification of the sovereign debt market and benefiting from the increased demand for Eurobonds generated by such improved market characteristics (De la Dehesa, 2011). As a further step, Eurobonds may be used to finance a Euro Zone budget, with the express function of allocating resources in order to eliminate asymmetric shocks and promote a more economically uniform Euro Zone.

The European lesson with regard to common currency areas is becoming clearer, illustrating the weak points of what can be defined as a still fragile structure. As was the case of many other pioneer projects, initial planning and strategy making have proved to cover just a limited number of particular cases of an economic climate and the time invalidation of a series of predictions referring to it proved to have a strong destabilizing effect, thus putting in danger the whole European common monetary future. The evolution of the Euro Zone, far from being completed, signals a series of warnings generated by the confrontation between economic theory and the realities of its actual implementation. Thus, the lack of fiscal integration represents an element of handicap which hinders any monetary union project and which needs to be responsibly addressed, even if this means that Member States will have to give up some of their national sovereignty.

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Annex 1
General government deficit/surplus (percentage of GDP)

	2008	2009	2010	2011	2012
Euro area (17 countries, not including Latvia)	-2.1	-6.4	-6.2	-4.2	-3.7
Belgium	-1	-5.6	-3.7	-3.7	-4
Germany	-0.,1	-3.1	-4.2	-0.8	0.1
Estonia	-2.9	-2	0.2	1.1	-0.2
Ireland	-7.4	-13.7	-30.6	-13.1	-8.2
Greece	-9.8	-15.7	-10.7	-9.5	-9
Spain	-4.5	-11.1	-9.6	-9.6	-10.6
France	-3.3	-7.5	-7.1	-5.3	-4.8
Italy	-2.7	-5.5	-4.5	-3.8	-3
Cyprus	0.9	-6.1	-5.3	-6.3	-6.4
Luxembourg	3.2	-0.7	-0.8	0.1	-0.6
Malta	-4.6	-3.7	-3.5	-2.8	-3.3
Netherlands	0.5	-5.6	-5.1	-4.3	-4.1
Austria	-0.9	-4.1	-4.5	-2.5	-2/5
Portugal	-3.6	-10.2	-9.8	-4.3	-6.4
Slovenia	-1.9	-6.3	-5.9	-6.3	-3.8
Slovakia	-2/1	-8	-7.7	-5.1	-4.5
Finland	4.4	-2.5	-2/5	-0.7	-1.8

Source: Eurostat

Annex 2
General government gross debt (Maastricht debt) (percentage of GDP)

	2008	2009	2010	2011	2012
Belgium	89.2	95.7	95.7	98	99.8
Germany	66.8	74.5	82.5	80	81
Estonia	4.5	7.1	6.7	6.1	9.8
Ireland	44.2	64.4	91.2	104.1	117.4
Greece	112.9	129.7	148.3	170.3	156.9
Spain	40.2	54	61.7	70.5	86
France	68.2	79.2	82.4	85.8	90.2
Italy	106.1	116.4	119.3	120.7	127
Cyprus	48.9	58.5	61.3	71.5	86.6
Luxembourg	14.4	15.5	19.5	18.7	21.7
Malta	60.9	66.5	66.8	69.5	71.3
Netherlands	58.5	60.8	63.4	65.7	71.3
Austria	63.8	69.2	72.3	72.8	74
Portugal	71.7	83.7	94	108.2	124.1
Slovenia	22	35.2	38.7	47.1	54.4
Slovakia	27.9	35.6	41	43.4	52.4
Finland	33.9	43.5	48.7	49.2	53.6

Source: Eurostat