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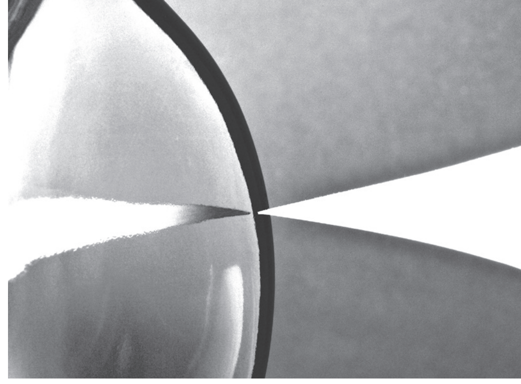

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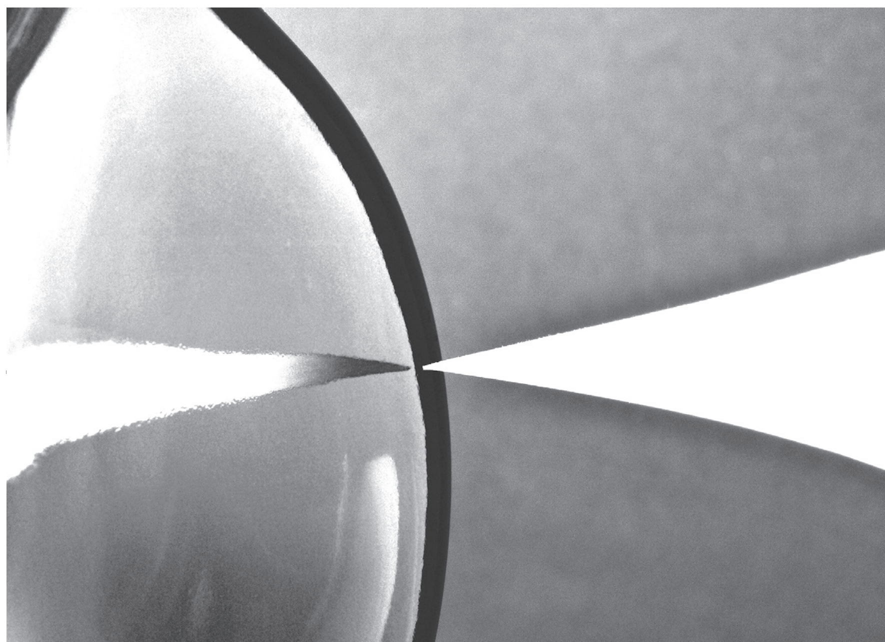

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**ONE CURRENCY, TWO EUROPES**
**Towards a Dual Eurozone**

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# Acronyms

| | |
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| 2008 SNA | System of National Accounts 2008 |
| ABCP | Asset-Backed Commercial Paper |
| ABSPP | Asset-Backed Securities Purchase Programme |
| APEC | Asia-Pacific Economic Cooperation |
| APP | Asset Purchase Programme |
| ASEAN | Association of Southeast Asian Nations |
| ASECs | Anglo-Saxon Eurozone Countries |
| BEA | Bureau of Economic Analysis |
| BEPG | Broad Economic Policy Guidelines |
| BRICS | Brazil, Russia, India, China, South Africa |
| BRPG | Broad Economic Policy Guidelines |
| CAB | Cyclically-Adjusted Budget Balance |
| CAP | Common Agricultural Policy |
| CBPP | Covered Bond Purchase Programme |
| CBPP1 | First Covered Bond Purchase Programme |
| CBPP2 | Second Covered Bond Purchase Programme |
| CBPP3 | Third Covered Bond Purchase Programme |
| CCBM | Correspondent Central Banking Model |
| CDS | Credit Default Swap |
| CEEC | Central and Eastern European Countries |
| CES | Comparative Economic Systems |
| CFSP | Common Foreign and Security Policy |
| CME | Coordinated Market Economies |
| DB | The World Bank's Doing Business |
| DFP | Distance to Frontier Score |

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|---|---|
| EAPG | Economic Adjustment Programme for Greece |
| EB | Executive Board of the ECB |
| EBA | European Banking Authority |
| EC | European Communities |
| ECA | Europe and Central Asia |
| ECB | European Central Bank |
| ECI | Europe 2020 Competitiveness Index |
| Ecofin | Economic and Financial Affairs Council |
| ECSC | European Coal and Steel Community |
| ECU | European Currency Unit |
| EDP | Excessive Deficit Procedure |
| EEC | European Economic Community |
| EFSF | European Financial Stability Facility |
| EFSI | European Fund for Strategic Investments |
| EFSM | European Financial Stabilisation Mechanism |
| EFTA | European Free Trade Association |
| EIB | European Investment Bank |
| EIOPA | European Insurance and Occupational Pensions Authority |
| ELA | Emergency Liquidity Assistance |
| EMI | European Monetary Institute |
| EMS | European Monetary System |
| EMU | Economic and Monetary Union |
| EOS | Executive Opinion Survey (World Economic Forum) |
| EPI | Environmental Performance Index |
| E+P | Euro Plus Pact |
| EPP | Economic Partnership Programme |
| EPU | European Payments Union |
| ERM | European Exchange Rate Mechanism |
| ERM II | Exchange Rate Mechanism II |
| ERPT | Exchange Rate Pass-Through |
| ESA 2010 | European System of National and Regional Accounts |
| ESAs | Joint Committee of the European Supervisory Authorities |
| ESCB | European System of Central Banks |
| ESFS | European System of Financial Supervision |
| ESM | European Stability Mechanism |
| ESMA | European Securities and Markets Authority |

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| | |
|---|---|
| ESRB | European Systemic Risk Board |
| EU | European Union |
| EU-15 | Pre-2004 15 EU Member Countries |
| EU-28 | 28 EU Member Countries |
| Euratom | European Atomic Energy Community |
| Eurostat | European Central Statistical Office |
| EUWIN | European Workplace Innovation Network |
| EVI | Economic Vulnerability Index |
| FDI | Foreign Direct Investment |
| FIRE | Finance, Insurance, and Real Estate |
| FTA | Free Trade Agreements |
| FTE S&E | Full-Time Equivalent Science and Engineering |
| GATT | General Agreement on Tariffs and Trade |
| GCI | Global Competitiveness Index |
| GDP | Gross Domestic Product |
| GeC | General Council of the ECB |
| GIA | Global Investment Attractiveness |
| GII | Global Innovation Index |
| GNI | Gross National Income |
| GNMA | Government National Mortgage Association |
| GoC | Governing Council of the ECB |
| HCI | Harmonised Competitiveness Indicators |
| HDI | Human Development Index |
| HICP | Harmonised Index of Consumer Prices |
| HMDA | Home Mortgage Disclosure Act |
| ICT | Information and Communications Technology |
| ILO | International Labour Organization |
| IMF | International Monetary Fund |
| IP | Intellectual Property |
| ITC | International Trade Centre |
| ITU | International Telecommunication Union |
| LDC | Least Developed Countries |
| LME | Liberal Market Economies |
| LTCM | Long-Term Capital Management |
| LTRO | Longer-Term Refinancing Operations |
| M&A | Mergers and Acquisitions |

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| MBS | Mortgage-Backed Securities |
| MIP | Macroeconomic Imbalances Procedure |
| MME | Mixed Market Economies |
| MMF | Money Market Mutual Fund |
| MoU | Memorandum of Understanding |
| MRO | Main Refinancing Operations |
| MTO | Medium-Term Objective for a Country's Budgetary Position |
| NAFTA | North American Free Trade Agreement |
| NCB | National Central Bank |
| NDI | Net Disposable Income |
| NECs | Northern Eurozone Countries |
| NEER | Nominal Effective Exchange Rate |
| NPISHs | Non-Profit Institutions Serving Households |
| NYSE | New York Stock Exchange |
| OCA | Optimum Currency Area |
| OECD | Organisation for Economic Cooperation and Development |
| OEEC | Organisation for European Economic Cooperation |
| OMI | ICC Open Markets Index |
| OMT | Outright Monetary Transactions |
| PCT | Patent Cooperation Treaty |
| PI(I)GS | Portugal, Ireland, (Italy), Greece, Spain |
| PISA | Programme for International Student Assessment |
| PJCC | Police and Judicial Cooperation in Criminal Matters |
| PM2.5 | Microgrammes of Particulate Matter Per Cubic Metre |
| PPP | Purchasing Power Parity |
| PSPP | Public Sector Purchase Programme |
| QE | Quantitative Easing |
| R&D | Research and Development |
| REER | Real Effective Exchange Rate |
| REPO | Repurchase Agreement |
| RTA | Regional Trade Agreement |
| RWC | Revised Washington Consensus |
| SCT | SEPA Credit Transfer |
| SDD | SEPA Direct Debit |

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| | |
|---|---|
| SEA | Single European Act |
| SECs | Southern Eurozone Countries |
| SEPA | Single Euro Payments Area |
| SGP | Stability and Growth Pact |
| SIV | Special Investment Vehicle |
| SME | Small and Medium-Sized Enterprise |
| SMP | Securities Markets Programme |
| SNA | System of National Accounts |
| SPV | Special Purpose Vehicles |
| SRB | Single Resolution Board |
| SRF | Single Resolution Fund |
| SRM | Single Resolution Mechanism |
| SSM | Single Supervisory Mechanism |
| SWOT | Strengths, Weaknesses, Opportunities and Threats |
| T2S | TARGET2-Securities |
| TARGET | Trans-European Automated Real-Time Gross Settlement Express Transfer System |
| TARGET2 | Second generation of TARGET |
| TCE | Transaction Costs Economics |
| TEU | Treaty on European Union (Maastricht Treaty) |
| TFEU | Treaty on the Functioning of the European Union (Lisbon Treaty) |
| TFP | Total Factor Productivity |
| TI | Transparency International |
| TLTRO | Targeted Longer-Term Refinancing Operation |
| TNC | Transnational Company |
| TOR | Traditional Own Resources (of the EU budget) |
| TSCG | Treaty on Stability, Coordination and Governance ("fiscal compact") |
| TTIP | Transatlantic Trade and Investment Partnership |
| ULC | Unit Labour Costs |
| UN | United Nations |
| UNDP | United Nations Development Programme |
| UNESCO | United Nations Organization for Educational, Scientific and Culture |

| | |
|---|---|
| VAT | Value Added Tax |
| VoC | Varieties of Capitalism |
| WB | World Bank |
| WEF | World Economic Forum |
| WIPO | World Intellectual Property Organization |
| WTO | World Trade Organization |
| ZLB | Zero Lower Bound |

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# Preface and Acknowledgments

This book is the outcome of a research that I started upon a challenging suggestion by Steven Rosefielde in 2009. Steven coordinated a research project that ended in a conference in Tokyo in 2010 and resulted in a book that he edited together with Masaaki Kuboniwa and Satoshi Mizobata (*Two Asias: The Emerging Postcrisis Divide*, World Scientific, 2011). In the research that I undertook for preparing the chapter, co-authored with Chiara Guglielmetti ("Eurozone and Global Financial Imbalances"), the evidence of a splitting Eurozone started to become clear.

Since then I had the opportunity to continue to work on the subject and present my ideas in various conferences and publications. In particular, important was the opportunity to work with colleagues at the University of North Carolina, especially John McGowan and, again, Steven Rosefielde, to organise two international conferences on the effects of the crisis in Europe: one in Trento in 2013 and another in Chapel Hill in 2014. These conferences were important for the intense discussion among participants from different continents and countries, and for the two books that I had the chance to co-edit with John McGowan (*Crises in Europe in the Transatlantic Context*, Routledge, 2014, and *A Global Perspective on the European Economic Crisis*, Routledge, 2016). Together, these experiences played an important role in developing my ideas about the crisis in Europe.

The topic appeared increasingly interesting, important and occasionally dramatic. I came to see it as a fundamental aspect of the European Union, an aspect that was growing in intensity under the blow of the international crisis. It was in particular the growing division of the Eurozone into two groups of countries in progressively different conditions that

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attracted my attention. This division was in a sense hidden for years, but with the crisis the split came to increasingly jeopardise the institutional and economic stability and the effectiveness of policymaking in the monetary union. In this way, the consequences of the division went to negatively affect the economic performance of the European Union, its political and social stability and its international role.

As a European with fair amount of international experience, I came to appreciate the precious achievements of European integration in both my scientific and teaching activities and in my daily life. As a teacher and researcher, I had innumerable opportunities to have European students in my classes, who were there thanks to European programmes. Similarly, many of my students had the opportunity to go to other European universities for periods of study. European integration made these opportunities much more important and numerous than we had when I was a student, with great benefit for students and teachers and hopefully the society at large. Similarly, teachers and researchers, among them myself, had the opportunity to interact strictly with European colleagues and participate in joint teaching programmes and research projects funded by the European Union. Having been involved directly in several of these programmes and projects, I could appreciate their importance and appeal, together with their complex management.

These achievements in the academic domain went in parallel with broader and more important advantages in the economic, political and social life. It appeared to me so evident that European integration has so many and so valuable advantages for everybody, that I found initially difficult to grasp the weak European reaction to the crisis and even more so the evident lack of an integration strategy up to the new challenges. Among the most important challenges, there is the increasingly wide and deep fault between those I call in this book vulnerable and resilient countries. This led me to research the causes for this apparently irrational and certainly weak response and behaviour, in an apparently lose-lose strategy.

As an Italian, the idea of the economic division of a country was not unfamiliar and so I was also motivated by the curiosity for a similar phenomenon in a different context. As a European living quite close to the border between the Northern European and the Mediterranean areas of the EU, which largely coincides with the split between resilient and

vulnerable countries, it was not difficult to appreciate the good reasons and the worries of both sides. I am convinced that solutions can be found to the present stalemate, but this requires a new approach to the economic and monetary union, based on the honest understanding of the reasons that led Europe into the present strain. This book is meant as a contribution to this fundamental debate.

When World Scientific proposed that I further developed my original chapter into a book, I was more than glad to do so. The outcome follows in the next pages. This would not have been possible without the support, stimulus and help of many people. Without any pretension of completeness, I limit myself to remind the colleagues who dared to read and comment on an earlier version of the manuscript. Although the responsibility of what follows rests solely with me, the result would have been different and certainly weaker without their effort and criticism. I want to thank in particular Klaus Gretschmann for the particularly precious and detailed notes he made to each chapter, as well as Chiara Guglielmetti, Paul Marer, Giovanni Pegoretti and Steven Rosefielde. Sara Giunti and Joseph Tixet helped me in collecting and elaborating statistics. My department gave me the time and the support to work on the book. My wife Agnes and my children Alice and Michele tolerated or perhaps forgot me during my mental and physical detachment when fighting with the manuscript and when I disappeared for days and nights in my studio. This book is dedicated to their patience and support.

Trento, 22 August 2015

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*"Of course there is always some gap between theory and practice. It is disastrous for both rulers and ruled when the gap becomes too wide."*

— A. J .P Taylor (1961, p. 57)

# Introduction: Prolegomena to the International Crisis

For decades, the construction of European integration was considered as the only solution to the problems that led this area of the world to turn into a "dark continent" (Mazower 1998). Although the continent was an area where so much of world civilisation took place, during much of the first part of the 20th century, Europe was both the perpetrator and victim of repeated political and social instability and tragedies that led to its economic and political decline on the world stage.

The economic integration and political coordination of a significant part of the continent was seen as the only effective answer to those dangers and the growing economic and political irrelevance of former world powers. For decades after its start, the construction of the European integration project was a great economic and political success, a success that peaked with the common currency. It was perceived to have provided a stable solution to the German problem that haunted Europe since the 19th century. It also apparently guaranteed that German reunification was

supporting European integration. It finally led supposedly to a "European Germany", obliterating previous hegemonic attempts in the direction of a "German Europe".

After 1989, much of the process of transformation going on in the eastern part of the continent converged rapidly to become an important part of European integration. This was perhaps the greatest testimony of the appeal of the European project, even though other factors were also significant. For instance, Central-Eastern European countries strived to enter the integration process for the unilateral economic and political advantages that membership had for them, for instance in the form of a net transfer of resources.

## The Crisis and Europe

On another stage, but directly involving European integration, the question of the possible obsolescence of the business cycle became dominant since the late 1960s (Bronfenbrenner 1969). The possibility of a major crisis, like the Great Depression of the 1930s, was considered an extremely unlikely event. This outcome was credited to either improved policies or the efficient working of markets, or to both. The belief was widespread among economists and other social scientists, policymakers, businessmen, the media, and the public at large. For a time, the Washington Consensus on policies (Williamson 1990) seemed to provide the correct approach and recipe to solve even the most difficult cases of countries in great financial and economic difficulty.[1]

The crisis started in 2008 in the United States and came as an economic and political blow that surprised most experts, policymakers and the public. The deep-seated belief of the impossibility or unlikelihood of

[1] John Williamson (1990) coined the term "Washington Consensus" to refer to a set of 10 economic policy prescriptions that the Washington-based institutions (the International Monetary Fund (IMF), World Bank and US Treasury Department) considered as the standard reform package for helping crisis-torn developing countries solve their economic and financial problems. Although these prescriptions shared an orientation towards a market-based approach, they should not be confused with the broader and more popular meaning that the term acquired as the expression of neoliberal or even market-fundamentalist policies. See also Williamson 1999, Williamson 2004a, Stiglitz 1998.

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a major crisis progressively and rapidly faded away from the start of the crisis in 2008. The experience of the crisis left a deep and long-lasting impact on the economies and on our way of perceiving the present and the future. Once it became indisputable that crises were still possible with devastating effects, the longheld belief and confidence in ever-growing economies faded away and were replaced by doubts about the forthcoming secular stagnation (IMF 2014a; Summers 2014).[2]

The following events showed that the EU was not immune to contagion and homemade distress. These events raised dramatic questions. Were the crisis and the European distress two unpredictable events, a couple of Black Swan occurrences (Taleb 2007)? Or were they linked together in an unpredictable super-Black Swan? In short, was it a question of objective unpredictability or ignorance? Or were both events the outcome of deeply flawed events and processes that happened previously and of decisions and arrangements that could have been predicted, at least as a possibility, to lead to greater difficulties and serious negative effects? If so, why was that possibility not considered and, more importantly, why were countermeasures not considered and enacted in time?

To be sure, criticism of the mainstream and popular conviction of the impossibility or at least the great implausibility of a major crisis, let alone a double dip, existed. Minsky (1982, 1992), in particular, warned that a major financial crisis was always possible. Shiller (2000) analysed the structural, cultural and psychological factors that cause the alternately soaring and declining of stock markets. Marxist social scholars traditionally maintained that major crises are necessary companions of capitalist economies (Dumenil and Levy 2011; Foster and McChesney 2013; Ticktin 2011).

Others, such as Bernanke (1983, 2004), Galbraith (1954, 1990), and Kindleberger (1978), studied the crises of the past and in particular the Great Depression of the 1930s to learn lessons on how to avoid and devise policies for similar crises in the future. Clearly, they were moved to such an undertaking by their implicit or explicit recognition that major crises

[2]"Secular stagnation and low potential growth in advanced economies remain important medium-term risks, given the modest and uneven growth in those economies despite very low interest rates and the easing of other brakes to the recovery" (IMF 2014a, p. XVI).

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were always possible and that it was important to understand and learn from the past to avoid future mistakes. Even some policymakers, such as the former chairman of the US Federal Reserve, Alan Greenspan, who cannot be absolved of the responsibility for creating the conditions for a major crisis through a policy of low interest rates and easy credit, spoke of "irrational exuberance" in 1996 when commenting on the excessiveness and dangerous instability of stock markets.

Although they could not avoid that the crisis broke out, these studies helped to avoid, in the United States and elsewhere, the policy mistakes that transformed the financial crash of 1929 into the Great Depression. Those teachings were not lost and, albeit with some hesitation, the US administration managed to react and avoid the old mistakes and helped the economy to recover.

The events in Europe were quite different. Apparently those teachings were largely unheeded and ignored. Or, for some reason, those teachings were not translated into practice when the crisis hit the European Union (EU) in 2008. In the case of the EU, therefore, it is fundamental to explain why the EU and its member countries did not follow the path that the United States undertook resolutely. In reality, this observation refers only to the Eurozone. In fact, EU member countries which do not share the common currency, e.g. Great Britain, adopted policies much closer to those implemented in the United States. This suggests that the difference may lie in the common currency.

The idea that the EU could be constructed through successive steps that would make the process irreversible, a kind of chain reaction, dates back to the founders of the unification process and its first steps. Progressive steps in the institutional construction of the EU, in particular moving policy functions to the supranational level, would create pressure for further steps, which would make the process irreversible. Jean Monnet,[3] who is regarded among the chief architects and founders of the EU, and other important European personalities (Padoa-Schioppa, Helmut Schmidt, Romano Prodi among others) shared this view (Guiso *et al.* 2014).

[3] Jean Monnet (1888–1979) was the first President of the High Authority of the European Coal and Steel Community (ECSC).

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The requirements and the consequences of a common currency were the concern of the European Community as early as the late 1960s. An important step in this perspective was the "Report to the Council and the Commission on the realisation by stages of Economic and Monetary Union in the Community", better known as the Werner Report (1970). The report stated clearly that:

> the advances towards integration will have the result that general economic disequilibrium in the member countries will have direct and rapid repercussions on the global evolution of the Community. The experience of recent years has clearly shown that such disequilibrium is likely to compromise seriously the integration realized in the liberation of the movement goods, services and capital. ... Having regard to the marked differences existing between the member countries in the realization of the objectives of growth and stability, there is a grave danger of disequilibria arising if economic policy cannot be harmonized effectively. The increasing interpenetration of the economies has entailed a weakening of autonomy for national economic policies. The control of economic policy has become all the more difficult because the loss of autonomy at the national level has not been compensated by the inauguration of Community policies. The inadequacies and disequilibrium that have occurred in the process realization of the Common Market are thus thrown into relief. (p. 8)

These words sound quite farsighted of today's problems and analyses. Yet four decades and a half have elapsed since then, without a decisive advancement to the structural and effective solution of those problems. Why is it so? Is it due to unforeseen and unpredictable events? The impossible unification of incompatible economies? Lack of cooperation and national opportunism? Policy mistakes? Biased institutions?

## The Strange Fate of Europe

The standard story of the international crisis is that it started in the United States and was due to lax regulation that fostered excess credit, financial and real disequilibria and bubbles. Although the crisis was

initially considered a major recession and in spite of massive government support to financial institutions in trouble, the crisis spread soon to the real economy and entered into a "second great contraction" (Reinhart and Rogoff 2009; Rogoff 2011).[4]

The global crisis started in the United States in 2008 and caught Europe unprepared. The EU had no ways of escaping the effects of the US crisis in a context of open and integrated markets and high mobility of resources. However, it was also under the effect of dangerous illusions about itself and its institutions.

Up to that time, the euro was a technical and economic success and supported real processes positively in most of the cases. Growth was dynamic in many latecomer countries, such as Ireland, Spain, and Greece. Popular support to the Union was strong and often enthusiastic, integration looked irreversible and enlargement proceeded briskly and gave the EU an international leadership role. Overall the federalist agenda looked strong and, in the economy, governments and markets appeared to believe in the existence of a common euro umbrella protecting all Eurozone countries, in spite of the severe Economic and Monetary Union (EMU) clauses.

Both internal and external factors explain European illusions at the beginning of the crisis in the US. Externally, the crisis initially appeared to be a domestic problem in the US due to imprudent financial liberalisation and the lack of prudent regulation, both typical of the American financial markets. Internally, the European Union, and particularly the Eurozone, were considered to be safer, thanks to the virtues of integration, the euro, prudent financial regulation and the sturdy features of continental European capitalism (Amable 2003; Hall and Soskice 2001; Hoffmann 2004; Morgan and Whitley 2012). The latter include lower financial depth and integration, conservative financial regulation and the prudent attitude of financial institutions, in particular strong (universal) banks.

Initially, the EU seemed to be effectively in a safe position, with the exception of macroeconomically unbalanced small economies (Greece,

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[4] "But the real problem is that the global economy is badly overleveraged, and there is no quick escape without a scheme to transfer wealth from creditors to debtors, either through defaults, financial repression, or inflation. A more accurate, if less reassuring, term for the ongoing crisis is the "Second Great Contraction" (Rogoff 2011).

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Hungary, and Ireland). In these economies, the crisis was already apparent in 2008. More than seven years into the crisis, this picture has dramatically changed. The Eurozone is now the problem of the world economy. Its financial situation is shaken, the Eurozone is split into two groups of resilient and vulnerable countries in strikingly different situations, the euro is in distress, and the very future of European integration is at stake. European policymakers are seriously debating and trying to find solutions amidst recurrent crises. Typically, policymaking is concentrated on financial and monetary issues, with institutional implications. The success of financial and monetary stabilisation is seen as a necessary precondition for the revival of the real economy. However, this takes place amidst growing doubts, policy inconsistencies and conflicts, as well as political and social protests. Policy dogmatisms apparently continue to prevail, and in reality, sound pragmatism has been replaced by muddling through issues. However, the real economy has barely moved and in some countries it continues to worsen. A stagnating or falling GDP, widespread unemployment, high inequalities and the danger of deflation are still important aspects of the Eurozone landscape in early 2015.

It is interesting to notice that the European Commission report on the first 10 years of the EMU stressed that disregarding non-fiscal dimensions such as competitiveness, credit booms and current-account deficits was a mistake (EC 2008a). However, since then financial issues have dominated debates and policymaking, and efforts have been focused on the need to strengthen the financial architecture and practice of the Eurozone and its member countries. Critical issues of the Eurozone such as diverging productivity among member countries, the sudden reversal of capital flows between the north and the south, the falling international competitiveness, and decreasing world trade shares are mostly confined to academic debate, barely appearing in governments' concerns.

This book seeks to demonstrate that a fault line is deepening within the Eurozone between vulnerable and resilient countries. Given the present institutional architecture and the priority assigned to financial discipline even to the disruption of real economies, the fault line is bound to dramatically worsen. At the end, this structural Eurozone dualism can jeopardise the sustainability of the common currency. The dramatic reality of the Eurozone is that concentrating on financial discipline is a one-sided

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approach that, alone, cannot resolve European troubles and is actually one of the main causes of those problems. At the same time, financial discipline cannot be disregarded or infringed in an institutionally incomplete monetary union, one in which trust among member countries is shaken to say the least.

Although it is true that the present financial distress of various EU member countries is a liability on their ability to grow, this is the case only in view of the present incomplete institutional architecture of the Union, and particularly of the Eurozone. However, if one takes a broader, longer and deeper perspective, it appears that the present financial and monetary crisis of the Eurozone is embedded in the real economy and the institutional architecture. In turn, the incompleteness of the latter reflects the strength of national sentiments and aims and the fundamental lack of trust among member countries, which the Eurozone tries to overcome by means of financial discipline. Moreover, concentrating on a fiscal and monetary solution to the crisis by means of restrictive policies is likely to be untenable in the medium–long run because of its depressive effects on the real economy, the heavy social costs, political deterioration and its fundamental conflict with national political sovereignty. The EuroGreek tragedy of the spring and summer of 2015 is full of important teachings in this sense.

Although some of the problems are common to the entire European Union, it is within the Eurozone that they are manifested in their fullest extent. Indeed, the common currency takes monetary policy out of the hands of national governments, which have to finance their activities in a currency that they do not control. Moreover, European treaties and the Stability and Growth Pact (SGP) strongly limit their fiscal policies. These constraints to policymaking exacerbate the effects of shocks, to the disadvantage of economies in vulnerable situations.[5]

[5] These are countries in an unbalanced macroeconomic or financial situation and whose economy is not competitive. They need policies to adjust their situation, but they miss policy sovereignty as members of a monetary union. External shocks may have particularly damaging consequences on these economies. The following countries are considered as vulnerable in this book: Cyprus, Greece, Ireland, Italy, Portugal, Spain. The following countries are considered as resilient: Austria, Belgium, Finland, France, Germany, Luxembourg, and the Netherlands.

The crisis has clarified beyond a doubt that the Eurozone includes economies with different features and in different, apparently divergent situations. Some economies are balanced and resilient, mostly in the north of the Eurozone; others are unbalanced and vulnerable, mostly in the south.

According to the literature on economic vulnerability and resilience (Briguglio *et al.* 2009; Cariolle 2011; Cordina 2004; Guillaumont 1999), economic vulnerability consists of the exposure and proneness of an economy to exogenous shocks and international market fluctuations.[6] More precisely, economic vulnerability results from a country's structural features that influence the size and likelihood of shocks and the exposure to these shocks and from the country's economic policies that determine the resilience to shocks. Therefore, there are both endogenous and exogenous causes of vulnerability. The opposite situation is one of economic resilience, which is the policy-induced ability of an economy to withstand or recover from the effects of such shocks.

Shocks typically arise out of economic openness and export concentration. The typical case is that of small countries, whose economies are, to a large extent, shaped by forces and processes largely outside of their control. Other factors of vulnerability are lack of diversification of production and foreign trade; exports with relatively high income and price elasticity; strong dependence on imports with low price elasticity and limited import substitution possibilities; insularity and remoteness, leading to high transport costs and reduced attractiveness for business and investment; absence of competitive markets; relatively large size of public sector activity in small countries; low absorption capacity for technology, investment and international development initiatives.

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[6] Since 2000, the United Nations Committee for Development Policy uses an Economic Vulnerability Index (EVI) as one of the criteria utilised, in addition to GDP per capita and the human capital (measured by the Human Asset Index), in order to identify Least Developed Countries (LDC). The Index is composed of seven indicators. These are grouped into factors of exposure (population size, remoteness from markets, export concentration, share of agriculture, forestry and fisheries in GDP) and factors determining the size and likelihood of shocks (share of homeless population due to natural disasters, instability of exports of goods and services, instability of agricultural production) (Guillaumont 2011 http://www.un.org/en/development/desa/policy/cdp/ldc/ldc_criteria.shtml).

Although not exactly the same as the case identified in this literature, particularly with reference to the causes of vulnerability, the case of vulnerable economies within the Eurozone is similar in terms of the effects. When hit by external shocks, these countries cannot freely use policy instruments to withstand or recover from the effects of such shocks, nor can they rely on the collective Eurozone support. Also in their case, there is typically an exogenous source of vulnerability.

Within the Eurozone, no country can freely dispose of monetary policy, since this is common. Moreover, no country can control the currency in which its budget and debt are denominated. However, asymmetric shocks (such as the appreciation of the common currency or the slump in the world demand) only hit negatively vulnerable economies, but not resilient ones. The difference can be explained in various ways, depending on the kind of shocks. Two factors are particularly important in the case of Eurozone countries. These are: first, macroeconomic, particularly financial disequilibrium, which shakes the confidence of financial markets in the solvency of those countries. A second factor includes microeconomic and systemic inefficiency, which leads to weak competitiveness. In both cases, the fundamental causes of disequilibrium and inefficiency are likely to be endogenous.

These economies are affected by unfavourable market events and conditions until the countries can solve their structural problems, which is quite difficult without policy sovereignty or European support. In principle, the problem of ailing competitiveness can be solved in three ways: currency depreciation, internal deflation ("austerity"), and reforms with investments.[7] In a split Eurozone, the choice is extremely difficult and ridden with intercountry conflicts of interests, along with domestic problems. The fundamental dilemma of the Eurozone lies in this conflict between the national goals of vulnerable countries and the goals of common stability, that largely coincide with the national goals of resilient countries.

[7] There is a further way: protectionism. Yet this solution is ruled out in a deeply integrated and open world economy ("globalisation"). And it is anyway contrary to the European principles and rules.

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## The Book

This book is about the strange case of the Eurozone crisis: a bold process of economic integration and monetary union turning into a cage, possibly into a liability or even a trap. How could it happen? Is it a case of an unforeseen event, a kind of Black Swan (Taleb 2007)? Or is it a foreseeable, and perhaps even foreseen, event that has so far found no solution for some unexplained reason?

The book aims at answering the following questions, each one treated in one or more dedicated chapters:

1. How was the world economy looking like in the decades that preceded the international crisis? Were there any factors and reasons for making the crisis inevitable or at least probable after decades of apparent obsolescence of business cycles and evaporation of major crises? And how did Europe fare in this context? Was it really an economically declining continent that was already weakened and vulnerable when the critical time arrived?
2. Why did a major crisis appear in 2008 and how did it unfold? Was it the effect of the mismanagement of the world's largest economy or was it the consequence of deeper and structural forces, whose destructive power accumulated in previous years and decades? Was it bound to unfold and multiply its effects to other countries in any case or were bad and wrong policies to be blamed? What was the true nature of this crisis? Was it embedded solely in the excessive expansion and lack of control over finance? Or were there (also) deeper and more structural reasons in the real economy?
3. Why did the contagion diffuse from the United States to Europe? Which forces, links, and processes transmitted the crisis to Europe? Were these of a financial or of a real nature? Was Europe a victim only of US economic mismanagement? Or did independent and self-made factors of vulnerability and unsustainability exist within Europe, factors that would have caused a major crisis anyway? If so, where could these factors be found? In the features and management of European economies? Or is the institutional build-up of European integration

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and unification to be blamed? And who is responsible for the European crisis: the EU and the Eurozone, Germany and other resilient countries, or vulnerable countries?

4. Is the implementation of the common currency bound to fail because of insurmountable flaws in its very nature? Was it wrong to introduce a common currency in a group of countries which do not share the necessary features? Are the Eurozone difficulties rooted in the lack of correspondence of this group of countries to the qualifications of an optimum currency area? Is therefore the currency structurally ineffective? Or is the lack of proper institutions and actions that made the common currency a liability?
5. Is the common currency really a liability? If the advantages of the common currency were considered to be greater than its disadvantages at the time of monetary unification, is it in the features and mismanagement of the common currency where we should look for the culprit of the European crisis? Were common institutions set up in a way and form that were inappropriate for a sound common currency? Should the introduction of the common currency have been prepared better and more resolutely? Are common institutions excessively incomplete or perhaps unbalanced and ineffective? Or is it in the unsolved balance between the union level and competences and roles of the national states where the fault line lies? Did the EU government commit mistakes or was it irresolute and powerless? Or were the economic situations of the member countries in the economic and monetary union diverging in such a way as to make the common currency and monetary policy a source of growing problems?
6. Once common institutions were settled in a group of countries that did not coincide with the requisites necessary for an optimum currency area, it was the turn of policies. Policies are fundamental for managing the common currency, answering threats to its stability, compensating for the lack of those institutions, and fixing the problematic consequences of the common currency. Are such policies properly and resolutely implemented? Do they have common stability as their goal or are they under the strain of national interests? Are common policymakers sovereign and determined in pursuing the common good?

7. Did the crisis hit the Eurozone when institutions and governance were still incomplete and insufficiently effective? Was then the crisis primarily a question of misfortune? Or did the implicit and hidden strain between common governance and national governments deprive common policies of a master? Were, as a consequence, common policies the outcome of a sub-optimal and unstable compromise between European government and national governments? Was the process of common policymaking excessively cumbersome, lengthy, ridden with uncertainty and consequently ineffective? What was the role of this unbalanced and uncertain setting for policymaking organs? Was it the cause or the perpetrator of ineffective policies and the European inability to effectively manage the crisis in a timely fashion? Did this situation cause the propagation of the crisis coming from outside? Did it trigger a domino effect, causing the crisis to spread within the Eurozone from one country to the next? Did it make the overall policy machinery ineffective or even pro-cyclical?
8. How should the history of the euro up to the crisis be considered? Was it really a success story? Or were the seeds of monetary troubles already germinating in the common currency? Were the European Central Bank's view, mission and management up to the challenge? Or were policies unbalanced and did they disregard fiscal and industrial policies? If so, did this disregard make a difference on the effect of monetary policies? What was the effect of fiscal management of member states under common rules for shared policies and crisis management? Is a currency union viable without a collective government of the economy?
9. Is the European Union in general and the Eurozone in particular really and fully aware of the unsustainability of the present institutional and policy situation? Are the present institutional reforms and policy refinements sufficient to meet the challenges? What is the role of national reforms and policymaking in improving the sustainability and policy effectiveness of the Eurozone? Are there any alternatives? Or is an uneasy and costly muddling through process and long-term stagnation the fate of the Eurozone?
10. What did the European management of the Greek crises show? Is this the victory of consistency to "protect and further solidify the foundation

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of the currency union", based on the conviction the "[b]enevolence comes before dissoluteness" (Schäuble 2015)? Is this the end of the European dream and the revival of the German problem for Europe? Is it the appearance of the much dreaded question of a "German Europe prevailing over European Germany" (Fischer 2015)? Or is it a masterpiece of European "constructive hypocrisy" (Kaletsky 2015) showing an unexpected way out of the rigid financial discipline that has prevailed thus far?