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"la Caixa" ECONOMIC PAPERS

No. 08 APRIL 2012

European Integration at the Crossroads*

Jordi Gual[1]

Abstract

This paper argues that deep economic integration, which includes the single market plus monetary union, leads to economic divergences if the integration process does not comprise an appropriate set of mutually complementary policies. The Eurozone is an example of an almost fully integrated area, which faces an extreme case of unbalanced integration. The paper argues that unless domestic structural reforms are adopted by the less competitive Member States, this is a policy framework that is unworkable without more political union. The gradual move to such an institutional setup would allow either the financing of chronic current account imbalances or the enforcement of the needed institutional changes at a Member State level to reduce those imbalances. The paper concludes that the new EU legislation, regarding budget deficits, current account disequilibria and banking, could even be counterproductive if it is only based on sanctions and does not incorporate positive incentive schemes.

JEL Codes: E02, F15, F36, O52

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1. Chief Economist at "la Caixa" and Professor at IESE Business School. I would like to acknowledge the help of S. Jódar, M. Noguer, O. Aspachs, A. Hernández and E. Fernández. All errors are mine.

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1. Introduction

The main thesis of this paper is very simple. If European integration is to be successful in the long run, it has to advance in a coherent way and should trigger structural and institutional changes in the Member States' economies.

As for coherence, at each stage of the integration process, there is a minimum set of consistent policies that is needed to ensure that integration advances in a balanced way and does not lead to fundamental divergences in economic performance.

Similarly, successful deep economic integration, which does not create unsustainable income divergences, requires profound economic reforms. Indeed, they are so significant and touch upon so many aspects of the social and economic fabric that it is unrealistic to expect that they can be imposed from Brussels with the current institutional arrangements and without resorting to a radically higher degree of political union.

If these two conditions, coherent policies and domestically driven structural and institutional changes, are not satisfied, European integration will lead to serious economic divergences. These disparities cannot be easily alleviated through intra-Eurozone transfers due to the insufficient political will of many Member States.

The coherence of the set of policies deployed at the European Union (EU) level is a matter to be decided by EU institutions, jointly with the Member States. As a result of the euro crisis, we are witnessing a lively debate about the policies that should complement the current arrangements within Economic and Monetary Union (EMU) and new legislation is being approved.

The structural changes must be decided by the countries themselves. As many have noted, they are in each country's best interest, since they will involve pro-growth domestic reforms even if the changes are painful in the short run. The reforms should not be imposed by regulations coming from the EU. If that is the case, it will be a further blow to the legitimacy of the Union, because EU rules are not currently perceived as being the result of a democratic process. Alternatively, of course, the EU could move decisively towards a full-fledged political union, but this does not look likely in the foreseeable future and the only chance of a successful transition towards deeper integration is the unilateral adoption of reforms by Member States.

This paper also argues that the new EU legislation regarding budget deficits, current account disequilibria, and banking could even be counterproductive if it is only based on sanctions and does not incorporate positive incentive schemes.

The paper is organized as follows. Section 1 develops the idea that deeper economic integration leads to economic divergences when the integration process is not well balanced, with an appropriate set of mutually complementary policies. It also argues that full (long run) integration leads to serious economic imbalances except, maybe, in an ideal world where frictions to factor movements and other market imperfections are removed.

Section 2 stresses that we are currently facing a very extreme case of unbalanced integration. On the one hand, EMU is missing some key complementary policies (basically on fiscal and banking issues). On the other, after the single market, the adoption of EMU is a large step towards full integration. It is argued that unless domestic structural reforms are adopted by the less competitive Member States, this is a policy that is unworkable without political union. Full political union provides the only institutional framework that allows the financing of chronic current account (CA) imbalances or the enforcement of the needed institutional changes at a Member State level to reduce those imbalances.

The paper concludes by arguing that the Eurozone should advance decisively in the direction of political union. The alternative poses a high risk of a breakdown of the single currency zone. Such an event would jeopardize the huge achievements of European integration so far and would lead to the political fragmentation of the continent, with dire consequences for all European nations and the world at large.

2. European integration and income convergence

This section explores the extent to which economic integration leads to income convergence or divergence between the areas that integrate. The analysis reviews the theory and the empirical evidence and concludes that the impact of integration on the extent of convergence depends critically on the nature of integration. The section considers first real integration, and then real *cum* financial integration, with a focus on Europe.

2.1. The theory

The general presumption by economists trained in the neoclassical tradition is that economic integration fosters income convergence[2]. Mainstream economic theory includes several key models that point in this direction. From trade theory, the various sources of gains from trade that derive from Heckscher-Ohlin and Ricardian trade models. From growth theory, standard neoclassical models, based on diminishing returns and access to technology by less developed regions or countries also posits catch-up processes that lead to income convergence.

The basic result of convergence is subject to significant qualifications even in the context of these basic theoretical models. For example, trade models make clear that trade integration creates winners and losers (both on an industry and on a territorial basis) and that the overall gains from trade accrue in the long run and assume some degree of compensation of the losers (see for example the discussion in Gual, 1995). Moreover, in practice the process of integration is likely to be imperfect, with political interference that may favor specific groups or countries. This is most likely to be important in regulated industries or in industries with increasing returns and/or network effects (Gual, 2008).

Beyond the canonical trade and growth models, economic theory has attempted to incorporate systematically into the framework the existence of increasing returns, scale economies and agglomeration externalities that may lead to important clustering effects. These new models have shown that the convergence result is far from established. Two recent literature strands that incorporate some of these phenomena point in fact towards divergence:

- new trade theory and new economic geography papers (see, for example, Krugman (1991), Krugman and Venables (1994) and Baldwin and Venables (1995)).
- new growth theory (among others, Romer (1990), Grossman and Helpman (1991) and Barro and Sala-i-Martin (1992)).

Summing up, the lack of conclusive theoretical arguments indicates that whether economic integration fosters income convergence or not is fundamentally an empirical issue to which we now turn.

2. The literature on growth and income convergence distinguishes between unconditional and conditional convergence. The first refers to convergence to a common steady state, with equalization of incomes. Conditional convergence depends upon different economies sharing similar fundamentals. In this case, economies converge to their own long run steady state income level.

2.2. The empirical evidence

Let us consider first the evidence regarding economic convergence at the international level. Most of the empirical literature finds that there is no unconditional income convergence. Periods of increased economic integration do not necessarily correspond to episodes of higher income convergence (Milanovic, 2006). An exception to this quite general result is the existence of what has been called "convergence clubs". That is, subsets of countries which are similar in their structural characteristics where convergence indeed takes place[3], the EU being of course the most important example (Ben David, 1993).

In fact, the absence of a generalized result of convergence is related to the paradox highlighted by Lucas (1990) many years ago. Lucas showed that in the case of the integration of capital flows, very often capital was flowing not where it was comparatively scarce, but where it was more productive in absolute terms; in the jargon of the literature, capital moved uphill.

In what follows, I will focus on the EU and draw a broad distinction between two integration periods: before and after the introduction of the euro[4]. For simplicity, I will call them real and financial integration periods.

Real integration

This is a period that comprises the gradual achievement of the free movement of goods through the elimination of tariffs and steps toward the integration of non-financial services markets thanks to the single market legislation. It is also a period of integration through the free movement of direct investment flows within the EU.

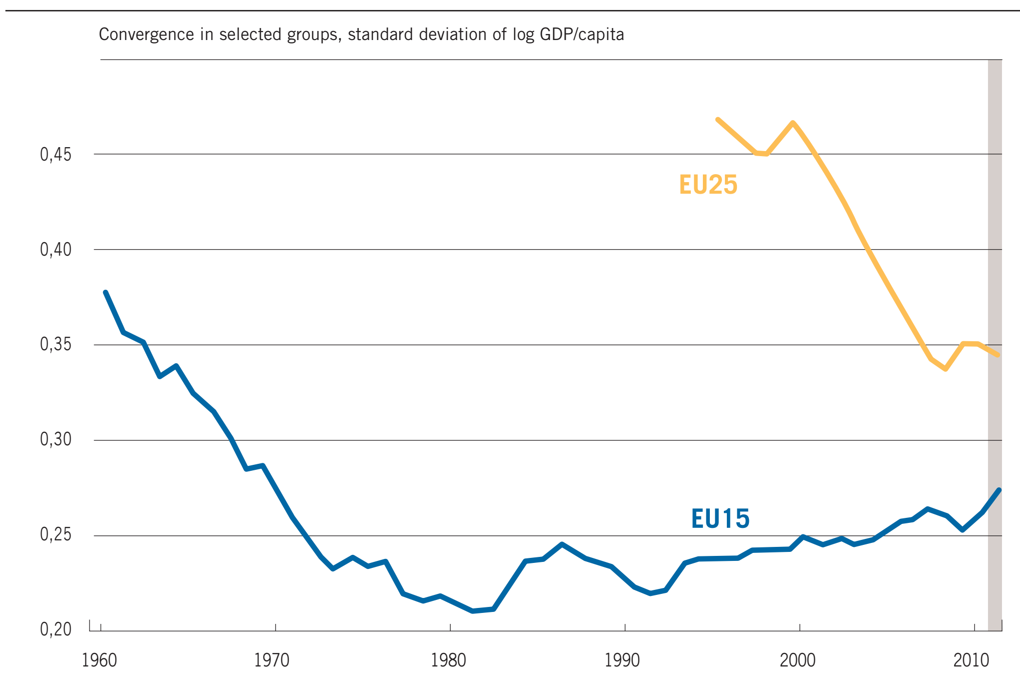
In principle, this process of trade liberalization should create large cross-border efficiency gains. As we know, flows in goods are a substitute for the flows in factors of production, to the extent that the goods embody those factors (Samuelson (1949)).

Within the EU this process of real integration has been traditionally complemented with regional policy initiatives. This has been the result, of course, of political agreements, but it also reflects the widespread belief among the different institutions involved that the integration process could have potentially harmful adjustment effects that would need to be cushioned.

Altogether, it appears that the overall effects of this process of real integration have indeed been positive in terms of convergence. As shown in figure 2.1**,** the EU15 countries converge clearly between 1960 and 1982, and so do the EU25 countries between 1995 and 2007. These are periods of trade liberalization and enlargement, which could certainly qualify under the general heading of periods of real integration.

3. It would be, then, a case of conditional convergence.
4. This is, of course, a gross simplification. The first 15 members of the EU were already starting the process of financial integration by the mid-90s, while the new Member States where at that time still experiencing the first stages of real integration. However, as I will argue, the introduction of the euro constitutes a turning point in terms of financial integration.

FIGURE 2.1 **Real integration and convergence in Europe**
Income convergence in Europe, 1960-2011*



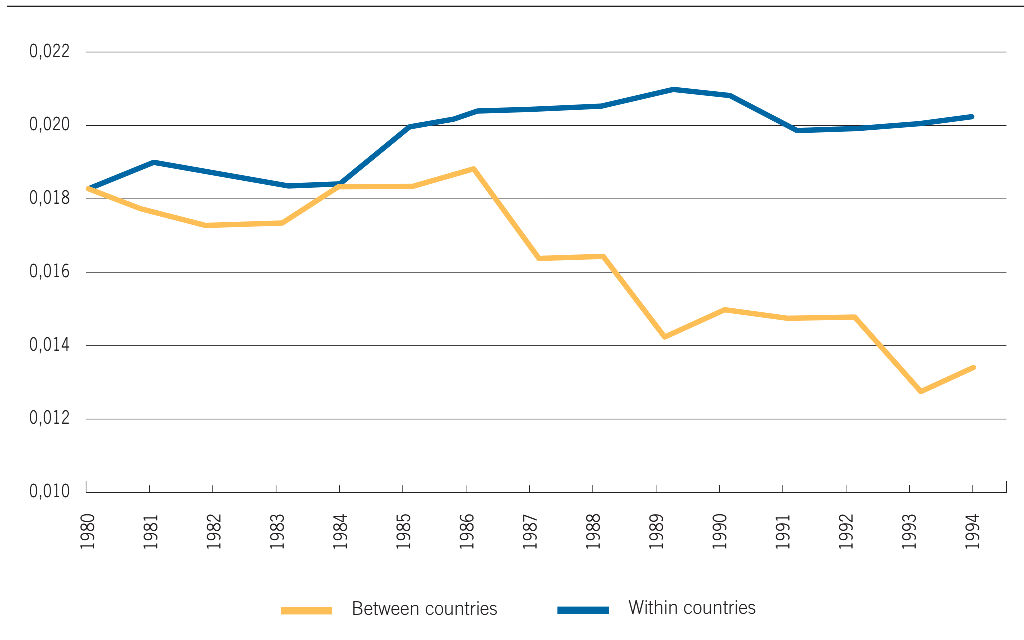
NOTE: (*) 2011 calculations based on IMF estimates.
SOURCE: Eurostat and IMF World Economic Outlook.

It is important to note that, while the EU has enlarged and deepened over the last fifty years, the evidence seems to show that we have observed indeed increased convergence between Member States but a remarkable lack of convergence within Member States.

This is shown in figures 2.2 and 2.3, which are based on the work of Esteban et al. (1999) and Paas and Schlitte (2007). Research conducted by Combes and Overman (2004) and Wilhelmsson (2009) shows that the results are valid when we include the period of enlargements towards the East.

FIGURE 2.2 **Convergence between, but not within Member States, 1980-1994**

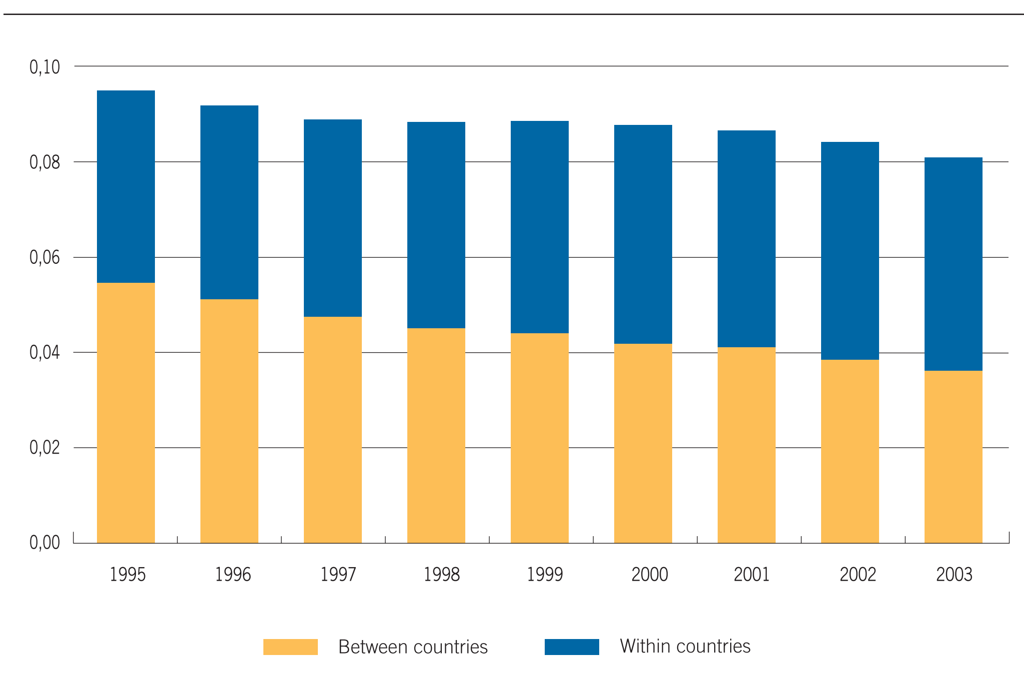
Inequality within and between countries of the EU11



NOTE: Measure of inequality: Theil Index.
SOURCE: Esteban, J.M. and J. Gual (1999).

FIGURE 2.3 **Convergence between, but not within Member States, 1995-2003**

Inequality between and within countries of the EU25



NOTE: Measure of inequality: Theil Index.
SOURCE: Paas, T. and F. Schlitte (2007), Hamburg Institute of International Economics Research Paper 1-11, using Eurostat (2007) data.

Financial integration

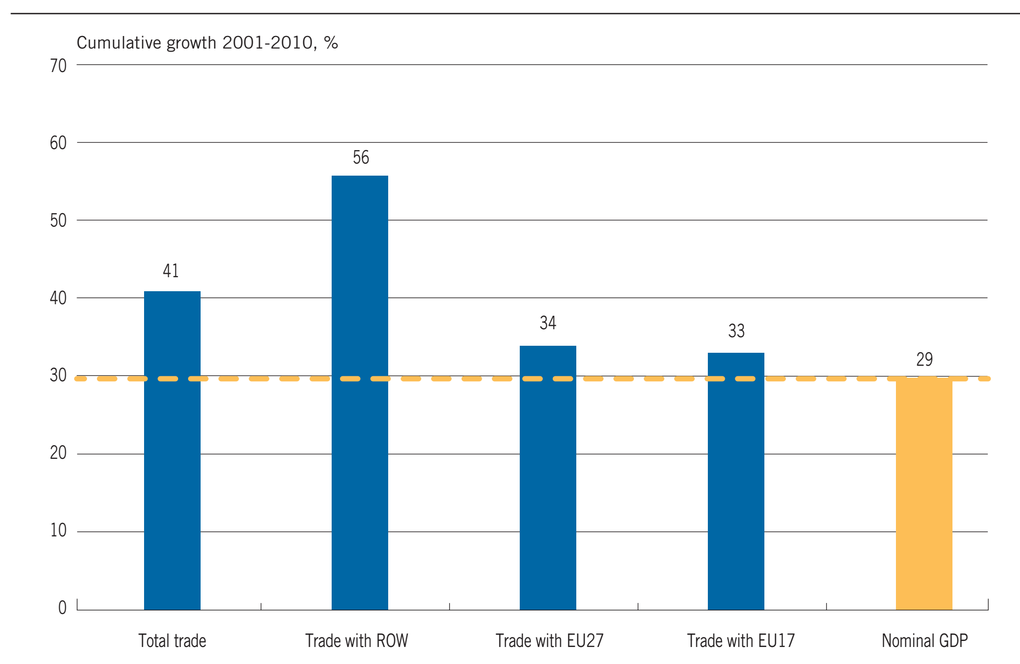
The onset of European Monetary Union was a turning point in terms of financial integration, with the introduction of the single currency, the complete elimination of barriers to both long term and short term financial flows and the gradual integration of wholesale financial markets. Of course, financial integration within the EU started earlier. At the macroeconomic level, with the introduction of fixed exchange rates (the European Monetary System, EMS) and the gradual capital account liberalization of the 80s and 90s. At a microeconomic level, with the legislation that introduced the single banking market over the same years. But with the introduction of the euro, which brought about the elimination of exchange risk and the single monetary policy, financial integration took a giant step with profoundly differentiated effects on the behavior of economic agents and the structure of markets.

Financial integration is a process that is supposed to generate economy-wide benefits through the efficient allocation across the Eurozone of investable funds. In principle, funds should flow from capital-rich countries to capital-scarce countries.

One could argue that it is too early to say whether this process of financial integration has fostered or not income convergence across the Eurozone. The analysis, based on the effects over thirteen years of EMU (1999-2011) and the foreseeable trends in income and integration, must therefore be preliminary.

The first fact to be highlighted is that EMU, contrary to what was argued in the famous *One Market One Money* report (European Commission, 1990), has not led to a higher degree of trade integration within the Eurozone. The famous quote of that report "a single currency and economic union complement the single market and add to its impact. One market needs one money") does not appear to hold true. Baldwin (2006) provides robust evidence on this matter. He found, half way through the last decade, that the single currency had had a modest effect on trade. Recent data are not encouraging either. Although a more detailed econometric analysis would of course be needed, the descriptive summary information provided by figure 2.4 shows that trade within the Eurozone (EU17 in this case) has not been particularly important as a driver of overall EU trade.

FIGURE 2.4 **The euro's impact on trade: much less than expected**[5]
Patterns of Eurozone Trade



SOURCE: Eurostat and IMF World Economic Outlook.

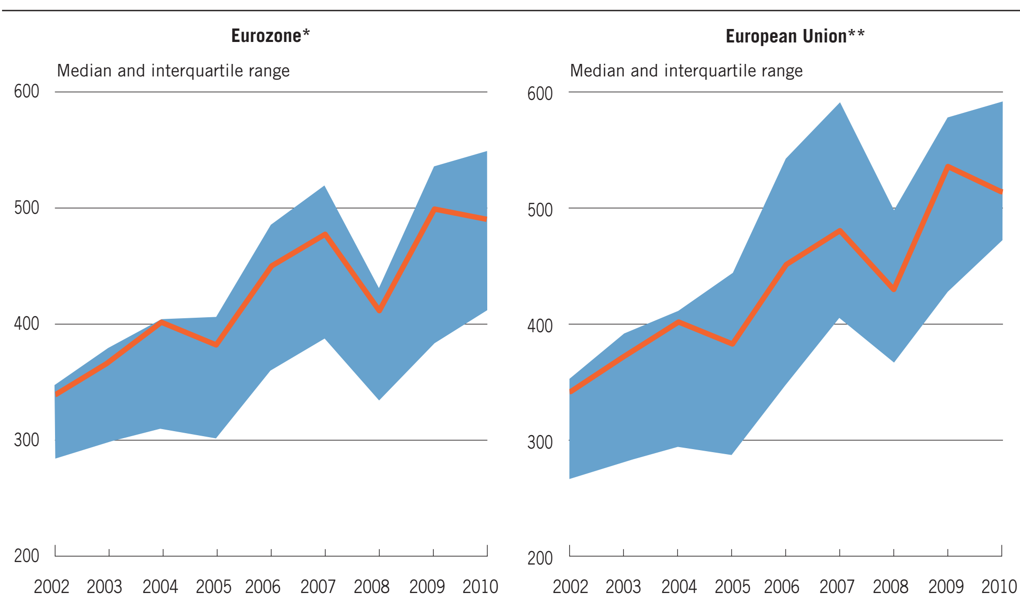
Hence, the euro appears to have played, at most, a modest role in fostering real economic integration. So, was it, at least, worthwhile in its own right as a mechanism of financial integration?

Research undertaken so far on the effect of the euro on financial integration and income convergence is, in my view, inconclusive. A very careful and detailed paper by Abiad, Leigh and Mody published in Economic Policy in 2009 finds that financial integration is a very significant phenomenon within EMU and concludes that it had positive effects on income convergence. However, as shown in figure 2.5, the increased degree of financial integration over the 2000s is not very different when we compare the Eurozone and the whole EU. The observed increase in integration could be simply a temporary phenomenon, linked to the long period of very low interest rates and the financial bubble experienced in many countries of Europe over the last decade.

In fact, one could argue that the indicator used by Abiad et al. measures nothing but the increased dispersion of cumulative current account imbalances, or net international investment positions which is of course a related magnitude. As we know, this is one of the major disequilibria that built during the first decade of the euro. The key issue is whether this was a force for income convergence within the Eurozone or an unsustainable trend.

5. I would like to thank professor J. M. Campa for discussions on this point and for providing the data used in the figure.

FIGURE 2.5 Financial integration in Europe, 2002-2010
Sum of foreign assets and foreign liabilities, in % of GDP

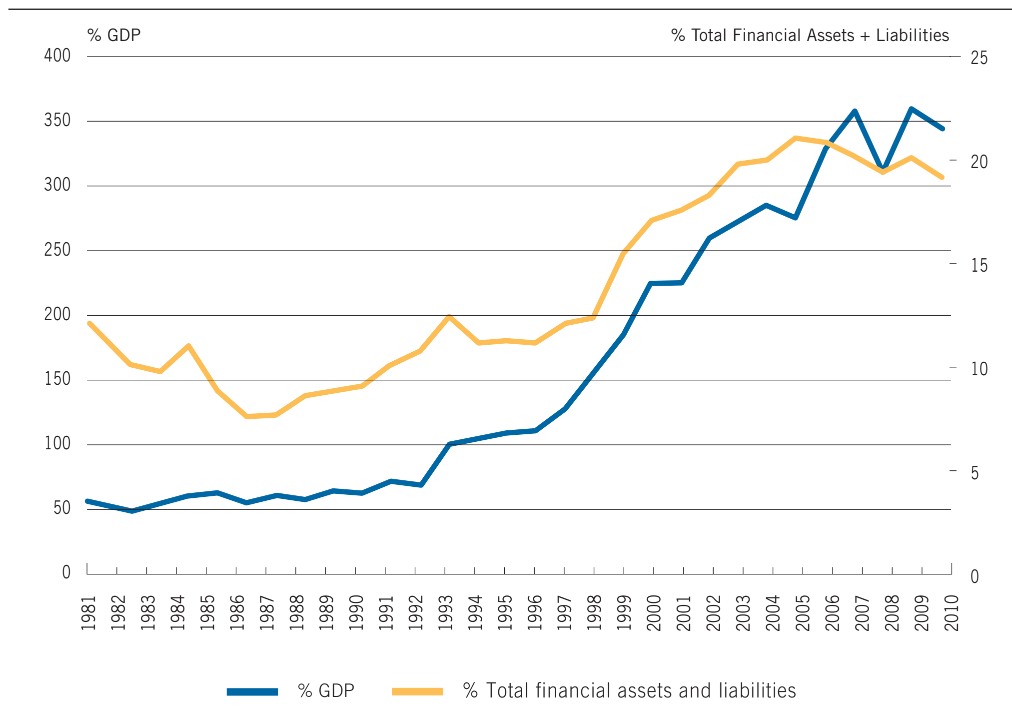


NOTES: (*) Austria, Finland, France, Germany, Greece, Portugal and Spain.
(**) Austria, Finland, France, Germany, Greece, Portugal, Spain, Hungary, Sweden and United Kingdom.
SOURCE: Total Foreign Assets and Liabilities, Datastream (IIP, IMF).

To control for the overall increase of indebtedness during the 2000s one can compute the weight of cross border assets and liabilities relative to total assets and liabilities. This is shown in figure 2.6 for the case of the Spanish economy. Even with this measure, the weight of cross-border assets might increase for reasons associated with the bubble, since external funds were the driver of the boom. But, as the figure shows, with this measure the extent of financial integration is much diminished relative to the GDP measure, and takes place basically during the first years after the introduction of the euro.

FIGURE 2.6 **Financial integration in Spain, 1980-2010**

Spain: Sum of foreign assets and foreign liabilities



SOURCE: Total Foreign Assets and Liabilities, Datastream (IIP, IMF). Financial assets and liabilities in Spain, Bank of Spain.

Moreover, as the debt crisis has unfolded in recent years, we have seen an increased fragmentation of national financial markets within the Eurozone. This is the case of public debt markets, interbank markets and even in terms of European Central Bank (ECB) policy (see, for example, Buiter 2012). It remains a question to what extent financial integration will be partially reversed over the coming years until the crisis is over.

The impact of integration on convergence is therefore quite an open issue. First, when properly measured, financial integration has not been as radical as once thought. And second, income convergence within the Eurozone, according to the data in figure 2.1, did in fact not improve between 1999 and 2011 and could even worsen significantly as some of the peripheral economies within the Eurozone contract in the on-going recession.

The experience of the initial years of the Eurozone leads us to the conclusion that financial integration is a process that if it is unbalanced (and more on this later), it creates substantial instability and leads to artificial booms and busts. This makes it difficult to assess its effect on income convergence. In that sense, financial integration is not very different from what happens to the capital account liberalization of emerging economies. It is also a process prone to excesses, which requires a mature domestic economy to absorb funds efficiently.

Specifically, to control and channel effectively those capital inflows what is needed is a domestic institutional structure with a fiscally sound public sector and a very flexible price/wage system, to prevent a real appreciation of the economy and the corresponding loss of competitiveness.

Apart from instability, financial integration has other important implications. In the case of Europe it involves the very last stage of economic integration, beyond real integration. As such, it may lead to increased divergence, as witnessed in many member states that being fully integrated (real and financially) maintain large internal income differences, which have not diminished during the period of European integration.

Real integration was, of course, achieved many years ago within Member States, and one can argue whether domestic rigidities (lack of labor mobility) and other interferences with the market (such as transfers that thwart factor flows and price adjustments) have prevented convergence or avoided even more extreme processes of divergence.

On the other hand, financial integration within a political entity is a gradual process akin to financial development. Arguably, within countries, financial development allows the financing of structural CA deficits. These are funded (at least partially) with inter-regional transfers as part of the domestic political equilibrium, something which is, of course, not presently envisaged in the Eurozone.

Overall, full integration in the long run within a country is only possible if there are fundamental changes in institutions that lead to convergence in productivity or unit labor costs, or alternatively, if the politically-determined transfers compensate for current account differentials that arise from the lack of institutional changes.

3. European integration: an unbalanced process at risk of derailing. Can it be fixed?

At each stage of the European integration process, there is a minimum set of policies, a policy package, which is needed to ensure that integration advances in a balanced way. This is a claim that can be posed purely on efficiency grounds, without reference to the distributional impact of integration. It refers to the synergies between policies that will often have to be exploited to reap the full benefits of integrating markets[6].

As an example, the policy that led to the creation of the internal market required the free movement of goods to be complemented by other policies, for the sake of efficiency. Otherwise, the initial policy becomes ineffective. Some policies, such as competition policy, had to be transferred to the EU level of government to ensure the efficiency of the internal market policy. The former Chancellor of Germany, Mr. Helmut Schmidt (2011), has recently reminded all Europeans that an adequate interpretation of the subsidiarity principle should work both ways. Sometimes towards devolution, but at several stages of the EU integration process, some policies are better undertaken at the EU level than at the Member State level.

Beyond efficiency arguments, it is well known that the process of integration created some fears of negative redistributive impacts even if they were believed to be temporary. For equity reasons, this led to the introduction of regional policies as a complement of the internal market policy. Balanced integration was achieved both on efficiency grounds but also from a political perspective.

A similar need for a comprehensive set of complementary policies was also advised at the time of the introduction of the euro and is needed still today at the EMU level.

Note, however, that while it is true that the *One Market One Money* report recognized that monetary union and fiscal policy are complementary

> "the future regime will still have to conciliate the need for a common standard of discipline over deficits and debt with that for flexible response at the national level to country-specific shocks";

it did not consider the possibility that EMU could end up leading to fundamental divergences:

> "The key to the catching-up process lies in obtaining synergies between Community and national efforts to upgrade the least favored regions (…)Equity as between countries and regions: opportunities and risks for all regions, and no a priori balance of relative advantage for the original or newer Member States. The least-favored regions have an opportunity for rapid catch-up. EMU, like 1992, is a positive-sum game".

On the other hand, the process of European integration has been the result of gradual advances with partial integration measures that have led to additional steps, often as a result of divergences or stress periods due to the insufficient coherence of EU policies.

6. On these issues see, for example, Pisani-Ferry (1995) and Begg et al. (1993).

The history of the construction of Europe is thus one of episodic tensions. Unbalanced integration leads to economic divergence, which risks undermining the process of integration and triggers further rounds of integration.

As an example of this recurrent theme in the history of the EU we need only recall that the period of integration in trade and services involved some (actual or feared) economic divergences, which were partially softened by EU transfers through cohesion funds and regional policy.

Tensions became more acute in the first stages of financial and monetary integration. Arguably, to prevent the breakdown of trade integration through competitive devaluations, controls were imposed on exchange rates. But these controls were undermined by fundamental economic divergences, as we witnessed during the EMS crisis in the 90s.

With the ongoing crisis, one could argue that the EU has achieved the maximum degree of stress. The Union is at the crossroads, where either decisions are taken that provide the complementary policies to make EMU viable, or the Union risks the unraveling of many years of European integration with a serious risk of protectionism, the breakdown of the single market and the fragmentation of the EU way beyond the demise of the single currency.

The debate is now, therefore, about the proper institutional architecture. How should the Union complement EMU with other policies in order to avoid its collapse? The focus in this paper is on long term solutions to the current crisis, and therefore I will assume that the ECB and the new European Stability Mechanism (ESM) provide sufficient liquidity and the appropriate firewalls so that the institutional reforms can be done in a matter of one or two years.

Three policy areas are critical for the proper functioning of the increased integration achieved in the monetary and financial domain: banking policy, fiscal policy and the set of policies that deal with current account imbalances[7]. Indeed, the three domains that I highlight are all witnessing legislative initiatives. Let me consider the three of them in turn.

3.1. Would EMU work better with new banking rules?

For many years European banking integration has been based on the concepts of the single passport and harmonized minimum prudential standards. This was complemented with home country supervision, while host countries were in charge only of financial stability concerns (Gual, 2004).

However, the huge cross-border exposures created by financial integration have revealed the flaws of this approach. Namely, the insufficient attention given by supervisors to EU wide problems and the lack of effectiveness of deposit guarantee schemes and bank resolution procedures when faced with cross-border banking crisis.

The current system does not provide the right incentives for banks, depositors and regulators to prevent excess exposures or to undertake timely intervention. Those incentives depend on

7. Note, by the way, that other popular areas of policy in recent years, such as services integration, energy, etc., do not seem to be that critical for the future of European integration.

who supervises cross border exposures, on who insures depositors and at what cost, and who bails out insolvent banks, if needed, for systemic reasons.

The required legal changes can be undertaken by the EU institutions and much is on its way (on these questions see Goodhart in this volume).

The new legislative proposals improve coordination between national supervisory authorities, increase the harmonization of deposit guarantee schemes (DGS) and foster a common resolution framework. They are, however, insufficient in so far as they prevent any actions by the central coordinating authority (the European Banking Authority) that may impinge upon the fiscal sovereignty of a Member State, and do not contemplate an EU wide DGS or a shared resolution fund.

3.2. Will EMU work better with the new fiscal regulations?

The new system of macroeconomic coordination and fiscal surveillance comprises a set of five regulations and one directive ("the Six Pack") and the new intergovernmental fiscal compact, signed on 1 March 2012 by most of the Eurozone Member States. These new legislation amends the Stability and Growth Pact and changes the overall governance structure of the Euro area. It establishes limits for certain fiscal variables (deficit and debt) and a system of surveillance and penalties for countries under an Excessive Deficit Procedure (see for a summary European Commission, 2012).

It is therefore a substantial upgrade of the former Stability and Growth Pact, with a broader set of restrictions on Member States fiscal policies. Rules are spelled out in more detail, with less room for interpretation and political interference; although the calculation of variables such as cyclically adjusted balances will not be exempt of controversy. However, enforcement risks remain: only experience will tell how harsh and serious will be the treatment of those who violate the rules.

In the short term, however, several forces push in the direction of further fiscal integration or risk sharing: the persistence of a large sovereign risk premium in certain countries, which could prevent them from exiting a deflationary recession; and doubts about whether the ESM would suffice if Italy or Spain needed liquidity assistance.

These short run forces have to be considered together with more fundamental arguments that point to the need of additional steps in fiscal integration. First, the new rules may reduce excessively the room for countercyclical fiscal policy at the national level, unless surpluses are run in good times. Will Member States be able to comply with these restrictions in the absence of an EU-level (federal) countercyclical fiscal policy? If this were not the case, it would constitute an efficiency argument for the application of subsidiarity, moving competences to the EU level of government and introducing a federal budget that can alleviate the impact of asymmetric shocks across the Union.

Second, the new framework establishes a system of incentives based on sanctions ("sticks"). It could clearly be strengthened with some "carrots" that reward good performance. One possibility would be access to cheaper forms of funding (so called stability bonds or eurobonds).

These carrots are particularly important because the incentive scheme has to be especially powerful in the absence of political union.

It is worthwhile noting, moreover, that the new fiscal rules may collide with the potential need for Member States to rescue their national banking systems, at a large fiscal cost. This leads of course to the previous discussion on the harmonization of banking regulation and resolution mechanisms as a complementary policy and the extent to which banking recapitalizations should be led by EU institutions.

On the other hand, the new system helps guaranteeing that countries will remain fiscally solvent, but liquidity crises will continue to be a possibility (even if their probability will have been reduced). There must be strong mechanisms to protect countries against liquidity crises (a large and flexible ESM).

Note finally that all these arguments are based on efficiency, without going into the equity issues, something which, indeed, was very much present in other periods of European integration.

In sum, as they stand the new fiscal rules are clearly insufficient. The regulation limits the room for maneuver of individual domestic policies without the gains from collective action (some degree of risk sharing and the benefits arising from the joint issuance of bonds in a very large and liquid market). These amendments would require wide-ranging modifications of the current institutional framework, and would have to be agreed upon at the EU level, but constitute a needed step to complement the present arrangements of the monetary union.

3.3. Will EMU work better with the new policies that deal with macroeconomic imbalances?

What is proposed is a system of surveillance and penalties of macroeconomic imbalances (the Alert Mechanism Report and the Macroeconomic Imbalances Procedure (MIP)[8]). One can think of them as a second phase of the Lisbon agenda, trying to achieve similar goals with an approach that moves beyond the previous intergovernmental benchmarking. It is an attempt to promote the competitiveness of Member States by the mandate of laws and regulations coming from the EU institutions much in the spirit of the Excessive Deficit Procedure, even if EU institutions have been at pains to highlight the strictly preventive nature of the indicators.

The system includes external imbalance indicators, non-fiscal internal imbalance indicators and fiscal balance indicators; with target thresholds for all of them (see European Commission, 2012).

Some concerns have been voiced regarding the quality of the indicators, the rationale of the threshold figures and the risk that the specific measure will become policy targets, even if the system explicitly states that a broad evaluation will be undertaken.

8. These procedures are also part of the “Six Pack” regulations approved in 2011 and monitored during the European Semester.

Overall, I believe this approach is misguided and unlikely to succeed. External imbalance indicators reflect fundamental competitiveness drivers, linked to embedded institutional features. Competitiveness draws on a variety of social and economic institutions that change slowly and are determined by the evolution of several deep-rooted social and political forces. These institutional and cultural changes are hard to achieve even within political unions, let alone in a loose confederation such as the EU.

Something similar could be said of non-fiscal imbalance indicators such as unemployment and, arguably to a lesser degree, with regards to debt and housing indicators.

Will structural reforms be enacted because of the threat of a fine? What would be the democratic legitimacy of those fines? At least in the case of the sanctions for fiscal policy, they have been agreed upon through the signing of a new Treaty. These sanctions for macroeconomic imbalances are the type of Community legislation that has proved unenforceable in the past because of the lack of political backing.

Is this better than the Lisbon Agenda approach? The previous framework was ineffective because of its intergovernmental and indicative nature. But the new one may even be counterproductive. The dimension of macroeconomic imbalances is, however, critical for the long run success of European integration. Nevertheless, the required structural changes cannot be imposed on the Member States. This would be in violation of democratic principles and counterproductive for the whole European project.

One possibility is for the European citizens to be convinced that the change in the rules is in their best interest; this, if at all possible, is likely to be a long process, on a time scale inconsistent with the decisions that have to be taken now, while ECB action and the ESM firewall provide a window of opportunity.

Alternatively, EU leaders could directly ask the population to form part of a EU-wide political union, with direct elections and sovereignty in the relevant issues being transferred to the new level of government. This is, as of mid-2012 utterly unrealistic, but of course it would guarantee that the rules enforced in any specific country to ensure its compatibility with the single currency would have the proper democratic legitimacy.

Finally, there might be a middle way, as in fiscal integration, with a system of incentives whereby countries are induced to change institutions by penalties and rewards. For example, to tie labor market reform to penalties, but also to EU (federal) funds for the unemployed if the reform is satisfactorily implemented.

4. Concluding remarks

Sometime in the late summer of 2011, before being nominated Prime Minister, it was precisely professor Mario Monti who wrote in the Financial Times[9] that the euro was supposed to achieve a task much more difficult than monetary stability: namely,

> "to induce a profound transformation not just of economic policies and structures but also of the institutions and the culture determining them."

He also argued that after thirteen years, the euro had achieved remarkably well its first goal, but that the

> "more difficult, objective – the structural convergence of economic cultures and policies – is being reached in a rather less straightforward manner."

That was obviously an understatement if we consider how painful and distressing the process of convergence of economic cultures and policies is. In the coming years, it is crucial that the leaders of the core economies in the Eurozone, and of course Germany, recognize the substantial efforts being undertaken by societies in the euro periphery, and complement the current policy stance –based almost exclusively on fiscal consolidation and the conditional and unpredictable intervention of the ECB– with policies that enhance growth at the core and, while preserving the right incentives, alleviate the funding squeeze in the periphery in a more foreseeable way.

This needs to be done, on purely efficiency grounds. But, of course, as former Chancellor Helmut Schmidt reminded the German people in December 2011 during the Congress of the SPD, the EU project is a political project, and more will have to be done –politically, on equity grounds–, if the Eurozone is to proceed ahead with full integration.

In the words of Mr. Helmut Schmidt:

> "Whatever Germany does or does not today, we all bear the responsibility for the future effects on Europe. We need European reason for this. But we do not need reason alone, we also need a sympathetic heart towards our neighbors and partners."

9. Financial Times, 28 September 2011.

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