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POLITICAL-ECONOMIC ORIGINS OF THE RECENT EURO CRISIS: A TALE OF A POLITICALLY-FAILING SINGLE-CURRENCY AREA

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1. INTRODUCTION

The global financial crisis which erupted in the United States instantaneously swept across Europe. Like the United States, the European Monetary Union (EMU) was ripe for a crash. It had its own real estate bubble, specifically in Ireland and Spain, indulged in excessive deficit spending, financially deregulated, and rapidly expanded credit (partly through derivatives).[1] Policy responses and recovery patterns for key EU members like Germany, France (within the Eurozone) and the United Kingdom (outside the Eurozone) were similar. However, after the bubble burst and the crisis began unfolding it became clear that the Eurozone plight differed from America's in one fundamental respect. There was no exact counterpart of Eurozone PIIGS (Portugal, Italy, Ireland, Greece and Spain) in the United States. Some American states had over-borrowed, but the sovereign debt crisis didn't place individual states at deflationary risk, or threaten the viability of the federal union. Not so for some members within the Eurozone. During the US savings and loans crisis in the 1980s, the American south-western states received a transfer from the rest of the US states equal to almost 20 percent of their gross domestic products. But, such a transfer has not been politically feasible within members of the EMU. The American experience therefore demonstrates that Europe's problem is not a pure economically failing single currency area; the failure is political in an institutional sense. Politicians on both sides of the Atlantic can be uncooperative, but inter-state disputes are more easily finessed under the American federal system than the Eurozone politically weakly integrated system.

The disparity is easily traced to the EU's and Eurozone's special form of governance called "supra-nationality" (a partially sovereign transnational organization) that has been largely ignored in economic treatises about the costs and benefits of customs unions, economic communities, and monetary unions.[2] Until now, it has been tacitly assumed either that supranational governance was as good, or better, than national economic mechanisms; that any policy regime accessible to nation states could be replicated without dysfunction by supranational communities.

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[1] European Financial Stability and Integration Report 2010, European Commission, Economic Staff Working Paper, Brussels, April 11, 2011.

[2] Wolfram Kaiser and Peter Starie, eds., Transnational European Union: Towards a Common Political Space, London: Routledge, 2009.

2. HISTORICAL TRENDS

Nation states before World War II never voluntarily surrendered their control over fiscal and monetary policy as part of a package to achieve political goals, even though they participated in international institutions like the League of Nations. The horrors of WWII, combined with cold war politics and the welfare state tide, however, propelled Europe along a novel supranational trajectory with some unintended consequences. On September 19, 1946 Winston Churchill gave a speech in Zurich not only advocating Franco-German rapproachement, but a kind of United States of Europe, called a European "Third Way." He also advocated a "Council of Europe". formed thereafter with the assistance of French Foreign Minister Robert Schuman, mandated to create supranational communities on the path to a fully democratic, integrated Union.[3] The Schuman Declaration May 9, 1950 reaffirmed the concept in conjunction with the formation of the European Coal and Steel Community (ESCS). It proclaimed the European Community as the world's first supranational institution, marking the "birth of modern Europe," and initiating an epoch where intra-European wars were impossible. The Soviet Bloc formed a rival economic community, the CMEA (Council for Mutual Economic Cooperation) in 1949, but Comecon, as it is sometimes called , was more a body for policy exchange, like the OECD (Organization for Economic Cooperation and Development), rather than a supranational economic governance mechanism superior to national authorities.[4]

Schuman's utopian vision which can be traced back to France's first socialist Claude Henri de Rouvroy, the Comte de Saint-Simon (1760-1825) [On the Reorganization of European Industry, 1814] was the prelude to a succession of developments culminating in today's European Union including the European Economic Community (EEC), known as the Common Market (1958), the European Community (1967) [together with the European Commission and the European Council of Ministers], the European Council (1974), the European Monetary System(1979), the European Parliament (1979), the Schengen Agreement (1985), The Single Market Act (1986), the Maastricht Treaty (1993) founding the European Union(EU), and the European Monetary Union (2002), which inaugurated the euro.

Europeans are broadly pleased with European integration. There has been no intra-member war, a common European identity has emerged, members are democratic and socially progressive, there is free travel, labor and capital mobility within the EU space, the economy has been liberalized, and living standards have risen. However, EU economic performance has hardly matched Schuman's idealist claims for supranational communitarianism. Growth has been anemic, unemployment high, and moral hazard problems severe. Supranational governors have found it easier to agree on broad principles, than to implement them and exercise fiscal discipline. Schuman felt sure that communitarians would be considerate, fair, self-restrained, and altruistic or could be tutored

[3] The term supranational community was coined by Jean Monnett, head of France's General Planning Commission.

[4] The members of CMEA were the Soviet Union, Poland, East Germany, Hungary, Czechoslovakia, Romania, Bulgaria, Cuba, Vietnam and Mongolia.

to act responsibly, but this proved to be the triumph of hope over experience. On one hand, the supranational deck was stacked in favor of over borrowing by the PIIGS and east Europeans. On the other hand, the PIIGS were misled into prematurely surrendering control over their monetary and exchange rate policy without receiving fiscal quid pro quos. As a consequence, the EU finds itself in an idealistically incorrect position, where the gap between rich and poor members is widening, at a time when supranational institutional arrangements are forcing the PIIGS to extricate themselves from their predicament with painful and problematic deflationary tactics necessary to regain their competitive strength; the so-called internal devaluation.

The contradictory social democratic mandate to bring ever more relatively poor countries into the fold, boosting their creditworthiness with implicit guarantees, pressuring them to adopt the euro, and straitjacketing their fiscal options, while undermining fiscal discipline with sympathetic approval of entitlements and leveling has solutions within a nation state framework (a true United States of Europe) that could be simulated by a supranational organization. However, this is extraodinarily difficult to accomplish because Schuman's communitarian optimism was misplaced. The EU has yet to find a supranational architecture that reconciles his idealism with workable macroeconomic regulation.[5] It is in this sense that the 2008 financial crisis's aftermath is more a culturally conditioned supranational institutional dilemma than a relatively simple matter of conventional international macroeconomic policy, and as such an overlooked element in the half century long debate on optimal economic and monetary unions and communities. If the EMU does eventually go the way of the CMEA, it won't be because economists failed to grasp the theory of unions and communities, but rather mainly because they didn't endogenize EMU supranational theory in institutional practice.

The power of this re-conceptualization is best appreciated by contrasting received wisdom on optimal currency union theory as it pertains to the EMU with the behavior implied by Schuman's supranational utopian vision.

3. THE EXPERIENCE UNDER A MONETARY UNION

The road to the European monetary unification, the centerpiece of a full European Economic Community and Union, went through the European Monetary System (EMS) 1979-1998, where eight member countries tried to dampen fluctuations in their foreign exchange rate parities.[6] They effectively pegged their currencies to the Deutsche Mark in an

[5] The supranational entitlement and moral hazard problem mirrors domestic disorders often said to cause Eurosschlerosis, but is potentially more pernicious because governments can borrow more than individuals.

[6] Daniel Gros and Niels Thygesen, European Monetary Integration, London: Longman, 1999. After the demise of the Bretton Woods system in 1971, most EEC members agreed to maintain stable foreign exchange rate parities. Fluctuations were restrict to no more than 2.25 percent (the European "currency snake"). The system was replace by the European Monetary System(EMS), and the European Currency Unit(ECU) was defined. It fixed parities, set an exchange rate mechanism(ERM), extended European credit facilities, and created a European Monetary Cooperation Fund that allocatd ECU to member centralbanks in exchange for gold and US dollar deposits. The German Deutsche Mark wass the defacto anchor because of

effort to curb inflation and advance towards European Monetary integration. The experiment failed. In 1992 important members of the EMS chose exit paths. Nonetheless, eleven members of the European Union upped the ante by choosing a solution that required more, rather than less cooperation. On Jaunuary 1, 1999 they created a common currency area (European Monetary Union: EMU) that effectively imposed a fixed exchange rate among all member countries. Participants surrendered their authority over national monetary policy and vested it in the supranational hands of the European Central Bank (ECB), forcing members to rely exclusively on fiscal and regulatory policy to manage macroeconomic disequilibria. The decision was an act of blind faith because many members failed to honor their Maastricht pledges to contain inflation and deficit spending prior to monetary union. Aspirants seeking EMU accession were supposed to hold inflation to no more than 1.5 percent per annum; to maintain a stable exchange rate with the ERM without devaluation, to run public sector deficits less than 3 percent of GDP, with a public debt under 60 percent of GDP. Many established members and aspirants alike flunked the tests after they joined the EMU, setting a pernicious precedent for future PIIGS.

Was this wise? Few pondered the precedent, focusing instead on first principles, but here too there were grounds for caution. The theory of optimal currency areas clearly implied that monetary union was not a one-way-street. Its merit depended on various tradeoffs. Milton Friedman observed that nations can deal more deftly with disorders if they have their own currency, allowing them to vary prices and wages, but this requires them to accept high costs of doing business across national boundaries. Consequently, monetary unions are attractive where the volume of intra-regional trade and labor mobility is high, and unattractive otherwise. The supranational fiscal regime likewise is a matter of concern. If it is strong, and tasked to assist members confronted with deficient aggregate effective demand, the risk members incur in surrendering the monetary option is partly compensated by pledges of supranational fiscal aid. If it is weak, nations place all their eggs in the supranational monetary basket, with no recourse other than accepting painful deflationary adjustments in order to regain competitiveness.

The United States provides a good example of an optimal currency area. It has a high volume of intra-national trade (Mckinnon). American labor is mobile (Mundell), and Washington has the muscle to effectively use fiscal power in alleviating distress in vulnerable states (Kenen). Also, the Federal Reserve has the authority to act as a "lender of last resort" if Washington's fiscal policy is insufficient (De Grauwe).[7]

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its relative strength and the country's low-inflation policies. In the early 1990s the EMS was strained by conflicting macroeconomic policies in Germany and England. Britain and Italy withdrew in 1992. Speculative attacks on the French Franc led to widening the band to 15 percent August 1993.

[7] See: Robert A. Mundell, "A Theory of Optimum Currency Areas," *Am. Econ. Reu*., Sept. 1961, 51, 657-64. ;Ronald I. McKinnon, "Optimum Currency Areas", The American Economic Review, Vol. 53, No. 4 (Sep., 1963), pp. 717-725; Kenen, Peter B. (1967), "Toward a Supranational Monetary System," in G. Pontecorvo, R.P. Shay, and A.G. Hart, eds., *Issues in Banking and Monetary Analysis,* New York: Holt, Reinhart, and Winston; and Paul De Grauwe, The Greek crisis and the future of the Eurozone The structural problem in the Eurozone is created by the fact that the monetary union is not embedded in a political union. Eurointelligence 11.03.2010. See also Paul De Grauwe, Economics of Monetary Union, New York: Oxford University Press, 2000.

The EMU by contrast is a dubious candidate for an optimal currency area because although it too trades intensively within the region, national work restrictions greatly impair intra-European labor mobility, and supranational fiscal power is feeble because rich members don't want to assume heavy financing burdens during turbulent times. The obverse also is true. Countries like Sweden and Norway which shunned the euro are thriving and appear to have benefited by retaining their monetary option.[8]

Robert Mundell and Marcus Fleming have succinctly formulated the problem bedeviling optimal currency unions,[9] particularly supranational ones in the form of a two-not-three trilemma.[10] Countries seeking to form a monetary union can enjoy two, but only two desirable policy goals: 1) free international capital flows (connected with optimal fiscal policy), 2) potent monetary policy to stabilize output, employment, inflation and financial markets, and 3) exchange rate stability. The United States picked free capital mobility and monetary independence, letting their foreign exchange rate float. China decided to retain its monetary independence and control its exchange rate, abandoning free capital flows, while the European Union has selected a third way. It mimicked the United States at the supranational level, accepting floating exchange rates for the euro, but at the national level failed to complement the choice with a supportive fiscal regime for distressed economies and friction free labor mobility, leaving vulnerable nations like the PIIGS in a lurch. When

[8] The same argument holds for North America. Canada's economy has performed well without forging a monetary union with the United States.

[9] Robert Mundell, "Capital Mobility and Stabilization Policy Under Fixed and Flexible Exchange Rates," Canadian Journal of Economic and Political Science, Vol.29, No. 4, 1963, pp.475-85. Marcus Fleming, "Domestic Financial Policies Under Fixed and Flexible Exchange Rates," IMF Staff Papers 9, 1962, pp.369-79.

[10] A **tri-lemma** is a situation in which someone faces a choice among three options, each of which comes with some inevitable problems, so that not all the three underlying policy objectives can be simultaneously accomplished. In **international finance**, the tri-lemma stems from the fact that, in most nations, economic policy makers would like to achieve the following goals.

First, make the country's economy open to international capital flows, because by doing so they let investors diversify their portfolios overseas and achieve risk sharing. They also benefit from the expertise brought to the country by foreign investors.

Second, use monetary policy as a tool to help stabilize inflation, output, and the financial sector in the economy. This is achieved as the central bank can increase the money supply and reduce interest rates when the economy is depressed, and reduce money growth and raise interest rates when it is overheated. Moreover, it can serve as a **lender of last resort** in case of financial panic.

Third, maintain stability in the exchange rate. This is because a volatile exchange rate, at times driven by speculation, can be a source of broader financial volatility, and makes it harder for households and businesses to trade in the world economy and for investors to plan for the future.

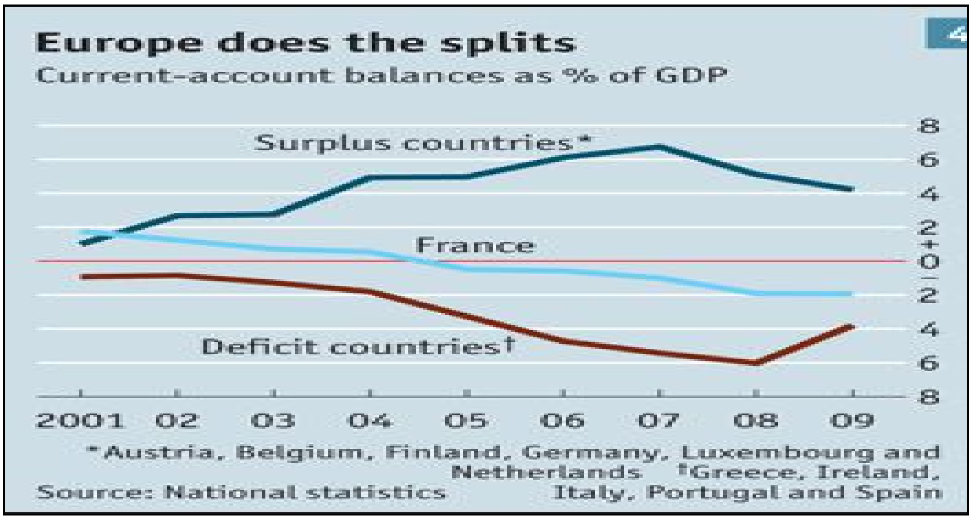
The problem, however, is that a country can only achieve adequately two of these three goals. By attempting to maintain a fixed exchange rate and capital mobility, the central bank loses its ability to control the interest rate or equivalently the monetary base – its policy instruments – as the interest rate becomes anchored to the world interest rate by the interest rate parity and the monetary base is automatically adjusted. This is the case of individual members of the EMU.

In order to keep control over the interest rate or equivalently the money supply, the central bank has to let the exchange rate float freely, as in the case of the US.

There are two basic types of trilemma. The most common occurs where people are compelled to choose among three undesirable options. The economic usage is different. Trilemmas here all involve favorable options, but picking any two precluding acquiring the third.

times are bad, the euro appreciates as investors shift to what they perceive as a German safe haven reducing the PIIGS export competitiveness, while idle labor in the periphery is prevented from migrating. What works for America, doesn't for the EU because of supranationality, the omitted variable in optimal monetary union discourse.[11] The trilemma solution for the PIIGS are three bads: no independent monetary policy, no independent exchange rate policy, and fiscal paralysis (due to excessive debt), while Germany and other current account surplus members retain free capital flows, a supranational monetary policy tailored to its needs, and an appreciating currency of its desire.

Figure 1
(The Economist, 2010) for the consequent divergencies within the EMU



4. INDIVIDUAL COUNTRIES EXPERIENCE

The PIIGS aren't entirely straitjacketed. They can extricate themselves from their plight with a "real depreciation" or "internal devaluation," but this is little consolation because it places an immense burden on prices, wages, and productivity growth in an adverse financial environment.[12]

[11] The ECB sets Eurozone wide interest rates, but if these rates are inappropriate for distressed economies like Greece, Athens lacks an independent currency to remedy the problem. Likewise it has no national central bank to act as "lender of last resort." THE ECB cannot act as a "lender of last resort" for Greek banks because it does not get easy mandate from its Board to do so for political reasons, as well as the fact that regulation of banks and deposit insurance is mostly in the hands of national authorities.

[12] Not all "internal depreciations" are intolerable. The reunification of East and West Germany provides a relatively painless example. Germany held wages down and increased productivity to alleviate unemployment and cope with income transfers flowing to the former communist east.

Superior German productivity growth, moreover, makes a bad situation for the PIIGS even worse.

Figure 2 (The Economist, 2011) reveals that PIIGS unit labor costs rose steadily 2001-2010, while German unit labor costs fell reciprocally. Ceteris paribus, the incentive for Germany to outsource and invest in PIIGS diminished at the same time foreigners were coaxed into diverting their purchases of EU exports from the PIIGS to Germany. Given the EMU's supranational straitjacket, there doesn't appear to any compelling reason to anticipate a swift reversal of the PIIGS's ill-fortune. A utopian welfare-state vision intended to ameliorate transnational income inequality, thus may perversely aggravate the problem.

Needless to say, this outcome was unintended, and indeed would not have occurred if PIIGS were virtuous Germans. They would not have assumed unmanageable debt obligations, and EU fiscal policy, monetary and foreign exchange rate policies would have been appropriate for them. These requirements however underscore two fundamental defects in the EMU supra-nationalism. First, the systems architecture is too rigid. A meritorious regime should provide good solutions across a wide spectrum of initial conditions. For the moment at least, the EMU has not devised the supplementary internal mechanisms needed to achieve efficient outcomes for all its members. Second, EU social democratic culture fostered values which enticed PIIGS to over extend themselves. They may well have done so on their own volition, but this doesn't change the fact that the Schuman ethos abetted their delinquency by encouraging them to believe in miracles and eternal free rides.

The weak link in Schuman's social democratic utopianism is a predilection for egalitarian outcomes combined with an ambivalent attitude toward equal effort and value added. EU leaders were pleased that the EMU enhanced the PIIGS's creditworthiness in private investors' eyes, and welcomed outsourcing from the wealthy core to the periphery. They were delighted that Germany, France, Britain and others shared in the windfall gains generated by these capital flows, and PIIGS's excess sovereign borrowing. This enthusiasm was tempered by the PIIGS's declining unit labor productivity and exorbitant social spending, but not enough to outweigh the satisfaction derived from narrowing the intra-union per capita income gap. Just as each EMU member state dislikes but tolerates the Euro-sclerosis fostered by equalizing outcomes, the European Council and parliament refrained from engaging the PIIGS on the issue. Moreover by raising the prospect of "haircuts" (debt forgiveness), they telegraphed the message that financial indiscipline and extravagant social programming ultimately may prove to be winning strategies. A culture that is ambivalent to moral hazard, is unintentionally apt to encourage it, adding to the distress causes by the systems faulty supranational architecture.

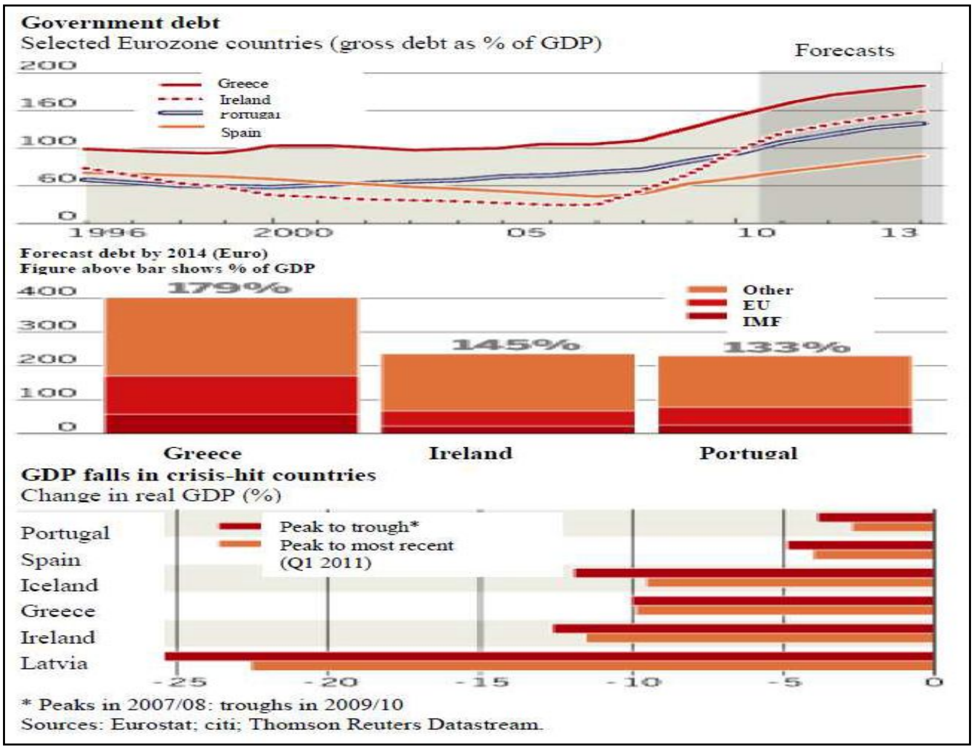
Speculative bubbles like the one sparked by EMU's contradictory welfare state political goals often end in crises. Investors panic when they discover that sand castles are crumbling, and debts may never be fully repaid even if they are restructured. This is what has been transpiring in fits and starts since the Autumn of 2010. Ireland was the first victim. Its toxic debt had been accumulating for a decade fueled by Irish bank borrowing in the international wholesale market to finance a property development bubble. When real estate crashed, private bank balance sheets melted down panicking the government into plugging the hole with a 50 billion euro commitment, equivalent to a third of Ireland's GDP. This dubious pledge was swiftly followed in 2008 by an equally ill-advised 100 percent guarantee of all bank deposits and most debt. The ECB joined the party allocating a quarter of its Eurozone lending to Irish banks by September-October 2010, all to no avail. Ireland ultimately managed to staunch runs on its private banks by borrowing approximately 145 billion dollars (70 percent of GDP), but this raised its government debt-to-GDP ratio to stratospheric Greek levels, effectively bankrupting the nation. The Irish government saved its banks and their creditors by forcing the Irish people to shoulder an unbearable burden. A 10 percent drop in GDP slashed jobs, driving the unemployment rate to 14 percent.

Spain's experience followed a similar script, but its real estate bubble which began in 1985 was home grown, with the government providing incentives for owning rather than renting, including 40 and even 50 year mortgages. Speculation accelerated after Spain adopted the euro driven by huge capital inflows until 2008 when the global financial crisis took the wind out of the real estate market's sails, throwing the country into deep recession. The national budget plummeted into deficit. It was 9.2 percent in 2010, and even if pared the debt-to-GDP ratio is expected to rise to 90 percent. On balance, Spain appears stronger than other PIIGS because of its relatively well regulated banking industry. However, Madrid is now in the thick of it. Further deterioration in housing prices in adverse times could threaten mortgage dependent private bank solvency, and intensify the decline in housing demand because under Spanish law evicted owners remain liable for their mortgage debt. A $120bn bailout of its banks appeared to have backfired. Because the rules of the rescue funds preclude direct equity injection into Spanish banks and rescue funds must be funneled via loans to the Spanish government,they pile up more debt onto the Spanish government, dragging it a step closer to a full sovereign bankruptcy. Private capital inflows dried up completely.

Greece's version of the supranational EMU melodrama has a different plot. The principal culprit in Hellas was unrestrained government welfare expenditures financed with overseas borrowing. Greek governments customarily have run large public deficits to fund government sector jobs, pensions and other social benefits since democracy was restored in 1974. Its debt-to-GDP ratio has exceeded 100 percent since 1993. The burden was softened before 2001 by drachma devaluation, but this option was foreclosed in 2001 when Greece adopted the euro. At first this didn't seem to matter because euro accession allowed Athens to finance debt on favorable terms, an advantage leveraged by persistently falsifying official data on the country's financial condition.[13] The chickens however finally came home to roost. On April 27, 2010, the Greek debt rating was cut to "junk" status by Standard & Poors. The ECB has tried to help by suspending its prohibition on buying junk collateral, but the situation continues deteriorating despite new austerity measures approved by parliament July 2011 in part because the fear of default raises interest costs that cannot be paid.

The best current estimates of the PIIGS's budgetary deficits and cumulative debt forecast that Greece's debt-to-GDP ratio will reach 180 in 2014. Ireland's plight will be nearly as dire with a debt-to-GDP ratio of 145, followed by Portugal at 135 and Spain 90.

Figure 3
(Martin Wolf, Financial Ti.mes, June 2011)



[13] Greece Paid Goldman $300 Million to Help it Hide its Ballooning Debts, according to http:www.businessinsider.com/henry-blodget, 2010-2.

Obviously, while Europe's sovereign debt crisis can go from bad to worse as Germany and France permit, the longer PIIGS debt problem is left unattended, the direr the consequences will be.

The maxim that the rich should pay at the supranational level means that the ECB, perhaps supplemented with new institutions will grudgingly provide loans to prevent PIIGS from defaulting on their sovereign debt. They also could provide "solidarity" grants by analogy with foreign catastrophe aid. If these tactics prove insufficient, wealthy EMU members like Germany and France can consent to partial "haircuts." This could be done in diverse ways, but the details aren't matters of high principle. What matters is that creditors will be transformed into limited liability partners sharing the cost of past transgressions so that debtors can have a fresh start without being formally cast into permanent default.

Paul De Grauwe (Grauwe, 2011) recently called for the ECB to be even more ambitious, serving as lender of last resort both to Eurozone member banks and those facing sovereign debt crises, stressing how easily liquidity crises can degenerate into system-wide insolvency. His argument is that sovereign debt in a single currency area is denominated in "foreign" money (money that cannot be issued by the governor of the individual member central bank), because the individual central bank cannot perform as “lender of last resort" by printing money. Only the ECB can do it and this requires complex coordination with other ECB governors, and governments. Therefore, he argues that it is wrong to restrict ECB monetary policy to inflation fighting, ignoring contagion of sovereign debt crises from one country to another as financial perils develop. Inflation fighting he insists, contrary to Goodfriend's advice (Goodfriend, 2011), must be integrated with a war against insolvency because the catastrophic potential of illiquidity breed insolvency dominate the moral hazard risk.

De Grauwe doesn’t downplay the moral hazard problem, but claims reassuringly that it can be managed by imposing rules that constrain government debt issuance. He is right in principle, but glosses the problem of supranationality. The sovereign debt crisis besetting the EMU today hasn't arisen because European Council encouraged PIIGS to misbehave, or the German's are fixated on inflation fighting. It erupted because the PIIGS refused to listen, and the rich members of the EMU refused to transfer income to the poor members. The EMU cannot compel them to desist regardless of whether the ECB adopts a conservative or liberal monetary regime.[14]

Protecting the people means placing a floor on the reduction of public spending in deficit countries. Schuman and others may have equated the notion with full employment and high aggregate economic activity, but idle chatter aside modern social democracies place much less weight on providing jobs and realizing production potential than on preserving government programs. Consequently, solving the debt crisis isn't a matter of economically optimal debt, but politically appropriate levels of excessive sovereign

[14] Paul De Grauwe, "The European Central Bank as a Lender of Last Resort,"August 19, 2011. Marvin Goodfriend, "Central Baking in the Credit Turmoil: An Assessment of Federal Reserve Practice," Journal of Monetary Economics, 2011.

borrowing, matched by extreme difficulty of income transfers among EMU member states taxpayers.

Thus, it is highly unlikely that the European Union will confront a moment of truth in the foreseeable future when members seriously contemplate secession. At the same time, it is highly unlikely that the rich EMU member states will foot the bill necessary to do a workable debt restructuring. Winners in the daily trench wars(as distinct from attaining the competitive ideal) like Germany which enjoys current account surpluses, high national savings, rising productivity and moderate per capita GDP growth risk losing more than they gain from exiting the EMU, even if they have to pay for partial haircuts. Germany still carries the baggage of distrust from the Nazi era, and is able to pursue its business and foreign policy agenda much more effectively under EMU cover than if it tried to prize similar concessions by other means. The French value the EMU relationship for other reasons, but like Germany are nowhere near the threshhold of secession.

The EMU's bailout of Greece on July 21, 2011 confirms this surmise. The eurozone countries and the International Monetary Fund(IMF) gave Greece a second bailout worth euro 109 billion(155 billion dollars), on top of the euro 110 billion granted a year ago. Banks and other private investors will add euro 50 billion (71 billion dollars) more to the rescue package until 2014 by either rolling over Greek bonds that they hold, swapping them for new ones with lower interest rates or selling the bonds back to Greece cheaply. The deal involving private creditors may well be deemed a "selective default" by rating agencies, making Greece the first euro country to ever be in default, but this isn't expected to have drastic consequences given the other positive aspects of the rescue package. To dampen adverse effects, the Eurozone will back new Greek bonds issued to banks with guarantees. This is essential because Greek banks use Greek government debt as collateral for emergency support from the European Central Bank. Those bonds would no longer qualify as collateral if hit with a default rating, meaning Greek banks would lose ECB support and quickly collapse. Bond rollovers, or swaps, were supposed to give Greece more time to recover and cut approximately 21 percent of its future debt burden.[15] Authorities agreed to provide the new eurozone rescue loans to Greece at a 3.5 percent interest rate, with maturities between 15 and 30 years, plus an additional 10 year grace period. Moreover, EU bailout overseers were given the power to intervene in countries before they are beset with full blown crises, an institutional reform opposed by Germany.

Nonetheless, this judgment should not be construed to mean that a default, should it occur, would be innocuous. The inflexibility of the EMU's supranational architecture raises the specter of hyper-deleveraging. For example, if the EMU's latest rescue plan for Greece proves inadequate and its sovereign debt goes into full default despite Eurozone guarantees, Greek bank lending capacity will plummet placing extraordinary downward pressure on wages, prices and aggregate effective demand because Athens doesn't control its interest rate (equivalently, its money supply) or foreign exchange rate. Argentina's experience in 2001 under less rigid conditions suggests that EU supranationality could make PIIGS pain

[15] The new Greek bonds issued to the banks would have long maturities of up to 30 years and low interest rates according to the Institute of Interntional Finance, the group representing private sector creditors. French President Nicolas Sarkozy estimated that the rates would average 4.5 percent.

and suffering a protracted ordeal.[16] Therefore, it can be reasonably concluded that the political and economic benefits of EU supranationality as they are currently constituted are asymmetric. PIIGS for their part regret having to pay the piper (creditors, reduced government spending, depression and mass unemployment), but the political and economic benefits of EMU membership, still lopsidedly exceed costs, even in a worst case scenario where defaults trigger a decade of suffering. They might contemplate exiting the EMU in order to increase the number of instruments for dealing with problems largely of their own making, but still value the EMU's benefits: enhanced creditworthiness and the possibility of compassionate transfers when the going gets tough. Moreover, rich members seeking to rid themselves of noisome PIIGS cannot compel them to exit the EMU by treaty, and practical difficulties will likely dissuade PIIGS from attempting to resurrect national currencies on their own.

The same principles apply for new entrants. Costs and benefits of EU (but not similarly to the EMU) accession will depend on each individual case more than generic economic considerations. It follows directly not only that talk of EMU, and or EU dissolution is premature, but EU enlargement considered the partnership's greatest foreign policy success, remains on track. Croatia is acceding, Montenegro and Macedonia are official candidates, and negotiations are in process for Turkey and Iceland. Preliminary discussions have been conducted with Russia.

5. A LOOK TOWARDS THE FUTURE

The substantive issue moving forward therefore is whether members are sufficiently dissatisfied with muddling through that they are willing to reform or ditch supranationality. Inertia favors doing nothing fundamental. Resistance to replacing member governance with unified federal rule is likely to be insurmountable now that the bloom is off the rose, while German and French authorities will be charier than ever of ceding ultimate control over the purse to supranational bodies. The EMU's inflexible supranational architecture is the patchwork result of contradictory goals and political interests, and pure institutional design.

[16] Miguel Kiguel, "Argentina and Greece: More Similarities than Differences in the Initial Conditions," August 16, 2011. Argentina, like Greece was confronted with a conundrum. It sought to restore access to the international capital market(sovereign debt problem) by raising taxes and cutting public expenditures to pay down its indebtedness . But, in doing so it risked making repayment more difficult by plunging the economy into deep depression. Kiguel argues that Argentina's budget cutting had precisely this adverse effect, and cautions the EU accordingly. His preferred solution is to hold the line on deficit spending insofar as possible, and promote productivity and competition with non-deflationary tactics. Another complementary approach that he fails to consider is steamrolling vested political interests, streamlining government services and earmarking savings for debt repayment. The structural similiarities between Argentina and Greece that guide Kiguel's recommendation are: 1) loss of devaluation option (currency board and dollarization in the Argentinian case; replacement of the drachma with the euro in the Greek case), 2) loss of access to the international capital market(excess sovereign debt), 3) and loss of monetary options due to dollar/euro-ization. On the policy front, both Argentina and Greece tried to acquire external assistance and ultimately failed to obtain enough. They also resorted to deflation to spur competitiveness, but here too were unsuccessful.

Any changes made therefore only are apt to improve flexibility at the margin rather than functioning as a viable surrogate for a unified state. As such reform may deter or mitigate crises in some instances, but shouldn't prevent them. Politics has been in command from the beginning, and continue to take precedence over economic potential and performance.

In the redesigning of the EMU, consider a European-wide bank deposit insurance and single bank-regulation authority as a means to prevent Europe financial contagion which is spreading across the Southern European countries. A banking union can be created only with greater political integration. From the Dutch and German point of view it is politically difficult, and unfair to their tax payers to underwrite the banks of the Southern European countries, using their own money to pay for generous social benefits that are more generous than those existing in their own countries. In a political union the Netherlands and Germany, being the source for the money transfer, will also have a say in leveling the generosity of social benefits across Europe, which can make it politically feasible to help sustain the European bank union.

The EU has wrought substantial political benefits including the democratization of new members and intra-European major war avoidance, but EMU architecture is comparatively economically inefficient, bubble prone and unusually subject to systemic risk. This package may be good enough for supporters of the welfare state, but emulators should weigh the evidence more judiciously. A greater political union is key to the preservation of the European monetary union.

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