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# Monetary Union and Fiscal and Macroeconomic Governance

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## Abstract

This paper analyses three questions related to the EU/EMU integration infrastructure: (i) interrelation between monetary and fiscal integration; (ii) interrelation between monetary integration and closer coordination of macroeconomic policies and (iii) fiscal discipline vs. fiscal solidarity. On the first issue, we suggest that rationale of further fiscal and political integration should be guided by the cost-benefit analysis based on the theory of fiscal federalism rather than OCA theory. On the second issue, we express conceptual and practical doubts regarding the way in which the Macroeconomic Imbalance Procedure has been designed and operated. On the third issue, we believe returning to the market discipline (based on credible danger of sovereign default) supplemented by clear and consistently enforced fiscal rules will have a key importance for long-term sustainability of a monetary union in Europe and avoiding dysfunctional fiscal federalism.

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# 1. Introduction

The European debt and financial crisis triggered a debate on the lacking components of the European Union (EU) and Economic and Monetary Union (EMU) integration architecture. This concerned, in first instance, a closer fiscal and macroeconomic policy integration. This debate has emerged on various occasions in the past, for example, during the negotiation of the Maastricht Treaty and before launching the EMU (late 1980s and 1990s) or during work on the so-called Constitutional Treaty in the first half of the 2000s. Many participants of the past and current debates, both advocates and skeptics of the common currency in Europe have underlined importance of closer fiscal, economic and political integration as a key condition of its survival (e.g., De Grauwe, 2006, 2013; Marzinotto, Sapir, & Wolff, 2011; Alphantery, 2012; Feldstein, 1997, 2012; Friedman, 1997). The European Commission (2012) in its 'Deep and Genuine EMU' blueprint presented the same approach. Subsequently, however, the President of the European Central Bank (ECB) Mario Draghi (2015) and the so-called Five-Presidents Report (Juncker et al., 2015) offered a less radical and more nuanced view.

Meanwhile several new integration measures have been adopted: the so-called Six-Pack (in force since December 2011) and Two-Pack (May 2013) legislations, the European Semester (operational since November 2010), the European Financial Stability Facility (EFSF, operational since June 2010) and European Stability Mechanism (ESM, operational since October 2012), the Treaty on Stability, Coordination and Governance in the EMU (the so-called Fiscal Compact, in force since January 1, 2013), and the Banking Union (2013). As they have been driven by anti-crisis policies and political window opportunities created by the crisis, it is desirable to make an interim assessment of the new institutional setup which has emerged so far. In broader conceptual terms, it is worth to ask the question which integration steps can make the single currency more resilient to potential adverse shocks (of various kinds) in future and which, on the contrary, make it more vulnerable.

The purpose of this essay is to analyze the newly established mechanisms of fiscal and macroeconomic governance and contribute to the debate on their further reforms. The essay draws from previous works of the author, especially Dabrowski (2008) on analytical approach to current account imbalances in the world of unrestricted capital movement and Dabrowski (2014) on the European fiscal union.

In the essay, we will concentrate on three issues, which have, in our opinion, the key importance for the entire debate:

- Interrelation between monetary and fiscal integration
- Interrelation between monetary integration and closer coordination of macroeconomic policies
- Fiscal discipline vs. fiscal solidarity

These three issues will structure further analysis presented in Sections 2-4, respectively. Section 5 will offer overall policy conclusions and recommendations.

Our analysis will involve interdisciplinary approach. Apart from economic analysis (with a focus on monetary theory and fiscal rules), economic history will also be employed. The empirical part will be based on comparison of historical and contemporary cases of monetary and fiscal unions and use analytical narrative method and simple statistical analysis.

## 2. Interrelation between monetary and fiscal integration

### 2.1. The debate on complementarity between monetary and fiscal integration

In the subsequent debates on the rationale and perspectives of the Eurozone, both supporters and opponents of the Euro project agreed it must be accompanied by a fiscal and political union in order to survive. However, while the former (e.g. Wolff, 2012) believed this was both possible and desirable, the latter (e.g. Feldstein, 1997; 2012) doubted it would ever happen due to a long historical tradition of sovereign nation states in Europe.

Unfortunately, these debates have suffered from numerous shortcomings. First, the notions of fiscal union and political union have been rarely defined in a precise way (if at all) what has led to frequent misinterpretation of the existing status of EU integration (see Section 2.2.2). The same concerns arguments in favor of political and fiscal integration as the condition for the monetary union's sustainability. Frequently, especially in the recent crisis-dominated hot debate, they have been taken as given. As a result, the claim for closer political and fiscal union sounded more like a creed rather than something based on well-founded academic arguments. De Grauwe (2006), who offers an in-depth discussion on interrelations between monetary and political/ fiscal union, and Aizenman (2013), who underlines the importance of a banking union (with its fiscal implications) for the stability of a common currency, are prominent exceptions here. However, a closer examination of interlinks between monetary and fiscal union on both a theoretical and empirical ground (see Dabrowski, 2014) provides us with a more nuanced picture.

### 2.2. Definitions

Before we move to theoretical and empirical analyses of interrelation between monetary and fiscal union we will try to define both concepts.

#### 2.2.1. Monetary union

Monetary union can be defined in both narrow and broad terms. In its narrow definition, monetary (or currency) union refers to situation when more than one territory (jurisdiction) share a common currency, and a single monetary and foreign exchange policy (Rosa, 2004). It can result from a bilateral or multilateral agreement when all interested parties decide to create/ share a common currency, common central bank and responsibility for joint monetary policymaking. This is the case of EMU, West African Economic and Monetary Union (WAEMU), Central African Economic and Monetary Community (CEMAC), Eastern Caribbean Currency Union (ECCU) and few other similar arrangements. Alternatively, a country may decide to use other country's currency based on its own unilateral decision, just giving up its monetary sovereignty. These are the contemporary cases of Panama, Ecuador, El Salvador and Zimbabwe (using the US dollar), Kosovo, Montenegro (using the Euro), Lichtenstein (using the Swiss franc), Nauru (using the Australian dollar), and few other countries.

Under a broader definition, the concept of monetary union also includes multiplicity of currencies that are linked each other through fixed exchange rates. Cohen (2008) calls this variant as an *exchange-rate union*, in opposition to *currency union* (see above). A fixed exchange rate can be set against either other currency or a common metallic standard (silver or gold). As in the case of narrow definition, the broad definition includes cases of multilateral or bilateral agreements such as the Bretton Woods system or the European Monetary System and countries' unilateral decisions. Among the latter, a *currency board* regime is the strongest arrangement.

Such a broader definition was assumed by Mundell (1961) in his seminal analysis of an optimal currency area (OCA) – see Section 2.3.

Obviously, there are important differences between *currency union* and *exchange-rate union*, even in its strongest *currency board* variant. In particular, they relate to costs of leaving monetary union, much higher when there is a common currency (Dabrowski, 2012a; Aslund, 2012).

### 2.2.2. Fiscal union

Unfortunately, there is no single and clear-cut definition of a fiscal union in economic literature. More interestingly, many of the authors who advocate building a fiscal union within the Eurozone (e.g., Marzinotto, B., Sapir, A. & Wolff, G., 2011) do not offer an explicit definition. In the debate on the causes of the European debt crisis and possible remedies, various practical meanings of fiscal union have been assumed by individual authors depending on their personal/ institutional views and opinions and which particular issues their analyses focus on. Thus, in various proposals related to changes in EU/EMU governance architecture, the notion of fiscal union may involve:

- a higher degree of centralization of fiscal resources at the Union level
- the development of European revenue sources for the EU budget (instead of the contributions of member states)
- a harmonization of taxation/ entitlements within the EU/EMU
- a mechanism of fiscal discipline at both the Union and national levels, including the mechanism of orderly sovereign default
- building up of Union-wide insurance mechanisms against financial turbulences (bailout facilities), including a debt mutualization mechanism
- the creation of institutions with fiscal authority on a supranational level (for example, creating an EU/EMU Ministry of Finance)

In our opinion, all of these proposals constitute elements of fiscal union, which can be defined, in very broad terms, as transfer of part of fiscal resources and competences in the area of fiscal policy and fiscal management from the national to supranational level.

Somewhat similarly, Fuest and Peichl (2012) distinguish five possible elements of fiscal union: (1) fiscal rules, policy coordination and supervision, (2) a crisis resolution mechanism, (3) joint guarantee for government debt, (4) fiscal equalization and other mechanisms of fiscal transfers between countries, (5) a larger EU budget and European taxes. At the same time they underline that ‘...a fiscal union may but does not have to include all five elements’ (p. 2).

Analysis of the current integration mechanisms and institutions within the EU leads to conclusion that they involve several ingredients of the fiscal union as discussed earlier: federal budget, including cross-country fiscal transfers, some elements of federal taxation, partial tax harmonization, fiscal discipline rules, fiscal crisis resolution mechanism and federal bailout facilities (see Dabrowski, 2014 for detail analysis). There are few additional fiscal integration mechanisms and facilities within the EMU, related to fiscal discipline rules, bailout facilities and (forthcoming) Eurozone-wide deposit insurance and banking-crisis resolution facilities. This contradicts frequent and somewhat surprising opinions that the EMU is a case of monetary union without a fiscal union (see e.g. Bordo et al., 2011; European Commission, 2012). On the other hand, this is a rather shallow fiscal union as measured by the degree of fiscal centralization (1% of EU member state’s Gross National Income or less plus bailing out funds within the EMU) and if compared with contemporary federal states (see Wyplosz, 2014).

Taking into consideration that the fiscal union already exists (although with various limitations), a call for supplementing monetary union with fiscal union can be interpreted as the postulate to increase the degree of fiscal centralization within the EMU.

Consequently, the existence of fiscal union, even the shallow one, means that the EU, in particular the Eurozone, also shares characteristics of political union, which can be understood as ceding part of national sovereignty to supranational bodies (in this concrete case – to the EU governing bodies). Apart from fiscal policy and fiscal management, EU member states have delegated to the EU level important prerogatives in the areas of trade policy, competition, internal market regulation, immigration, justice and home affairs, agriculture and fishery and many others. Most importantly, the decision of creating the common currency and central bank represented another important step towards political unification (Draghi, 2015).

### 2.3. Theoretical foundations

Looking for conceptual foundations of the analysis of interrelation between monetary and fiscal union, we will briefly review two pieces of economic theory: (i) OCA theory, which analyzes economic conditions, under which a common currency can function effectively, and (ii) theory of fiscal federalism, which offers criteria of fiscal centralization and decentralization.

#### 2.3.1. OCA theory

According to the original version of the OCA theory as developed by Mundell (1961) and McKinnon (1963), fiscal policy can cushion the consequences of asymmetric shocks in cases where free mobility of production factors (labor and capital) is insufficient to do so. However, this part of OCA theory may be interpreted in two ways: either as the retention of fiscal capacity and sufficient fiscal buffers in territories participating in a common currency area to enable them to respond to idiosyncratic shocks in a decentralized way (in the absence of monetary accommodation) or the necessity to arrange cross-territorial fiscal transfers. This second solution may have advantage of reducing the risk of uncoordinated, idiosyncratic fiscal responses conducted in a decentralized way, which can produce additional unnecessary shocks (Cottarelli, 2012a).

The first interpretation stayed behind the original design of the Maastricht Treaty and the Stability and Growth Pact (SGP) (see Mortensen, 2004; De Grauwe, 2006). The second one seems to dominate in the post-2010 debate (e.g., Wolff, 2012). The reason of such shift may relate to failure of building sufficient room for countercyclical fiscal policy on national level prior to the global and European financial crisis, resulting from insufficient fiscal discipline (see Section 4.3).

Another possible view is that fiscal policy interventions, especially in the form of cross-territorial transfers, represent the second-best response to idiosyncratic shocks, in comparison with free mobility of production factors. Such a conclusion can be drawn indirectly from the OCA theory itself (Mundell, 1961). Consequently, policy recommendations may suggest concentrating on increasing flexibility and transparency of labor, capital, product and service markets instead of insisting on higher degree of cross-territorial fiscal redistribution (see Fuest and Peichl, 2012; Issing, 2013; Balcerowicz, 2014; Draghi, 2015).

There is also the question of how big is the risk of idiosyncratic shocks within the Eurozone. According to the original OCA theory, the concept of idiosyncratic shocks relates to real external shocks affecting respective territories in different way, i.e., factors beyond policy control – see the example of shift of external demand from goods produced by territory B to goods produced by territory A, in Mundell (1961). Looking back for more than 15 years of history of the European common currency it is hard to detect such major asymmetric shocks<sup>1</sup>.

Two biggest shocks (of 2008-2009 and 2010-2013) were caused by the financial crisis, so they had nominal rather than real character. The first stage of the global financial crisis (2008-2009) had largely external origins (crisis in the US financial sector) and affected negatively all EU and EMU members, in one way or another. Thus, it is hard to argue about its asymmetric character.

On the contrary, the second stage of financial crisis (2010-2013) affected directly only part of the Eurozone, its so-called periphery. Indeed, it had an asymmetric character, however, not originating from the real sphere<sup>2</sup> but from imprudent fiscal policies and banking supervision in individual member states then reinforced by the market fear that crisis-affected countries may leave the common currency area. Thus, they were policy-induced and one can say about idiosyncratic policies rather than idiosyncratic shocks in the OCA theory sense (see Cottarelli, 2012a). In such circumstances, effectiveness of using fiscal transfers as remedy remains questionable. We will return to this issue in Section 2.5 and Section 4.

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<sup>1</sup> In this respect our opinion differs from those of Rey (2013) and Wyplosz (2015). The latter considers ‘...highly differentiated debt buildups on highly diverse initial debt level positions as well as different inflation and current account evolutions’ as evidence of asymmetric shocks (in the OCA theory sense) affecting the Eurozone and confirmation ‘...that the Eurozone is not an OCA.’

<sup>2</sup> Cottarelli (2012a) mentions ‘globalization’ shock suffered by Italy and Portugal, which produced low-value added goods and faced increasing competition of emerging-market producers. Indeed, it represented asymmetric shock in terms of OCA theory. However, in our opinion, its contribution to financial shock experienced by both countries in 2010-2013 (which originated from sovereign over-indebtedness) was limited and indirect.

### 2.3.2. Theory of fiscal federalism

When discussing economic rationale of closer fiscal integration within the EU and EMU, the *theory of fiscal federalism* should serve as primary guidance, similarly to the role of OCA theory in the debate on monetary integration. This theory helps us understand “*which functions and instruments are best centralized and which are best placed in the sphere of decentralized levels of government*” (Oates, 1999, p.1120).

Thus, discussion about the perspective of closer fiscal integration in Europe should start from a functional analysis aimed at identifying those policy areas and public goods where the centralization of competences and resources could either offer increasing returns to scale or help address cross-border externalities<sup>3</sup>. As result, any further fiscal integration should be justified by potential benefits of pooling resources to carry out common policies and provide supranational public goods rather than by the very idea of a closer fiscal union itself. In the context of our analysis, this means that potential benefits of greater fiscal centralization (for monetary union stability and sustainability) should outweigh its potential costs in the form of lower efficiency of centralized expenditure (as compared to decentralized), wrong policy incentives on national level (risk of moral hazard and free riding) or redistribution conflict between members states.

### 2.4. Examples of other monetary unions

Empirical analysis requires comparison of the current institutional architecture of the EMU with other past or contemporary monetary unions. Most frequently, the EMU is compared with the US (see e.g., Bordo et al, 2011; Henning & Kessler, 2012; Gros, 2013), which may be justified by the similar size of economies, their global importance and the role of the US as the major EU’s partner and competitor. However, such comparison suffers from several shortcomings.

First, it disregards different political and institutional characteristics of both: while the US is a federal state, the EU and EMU remain closer to the model of confederation (in which member states delegate only part of their sovereignty to supranational organs) rather than federation<sup>4</sup>.

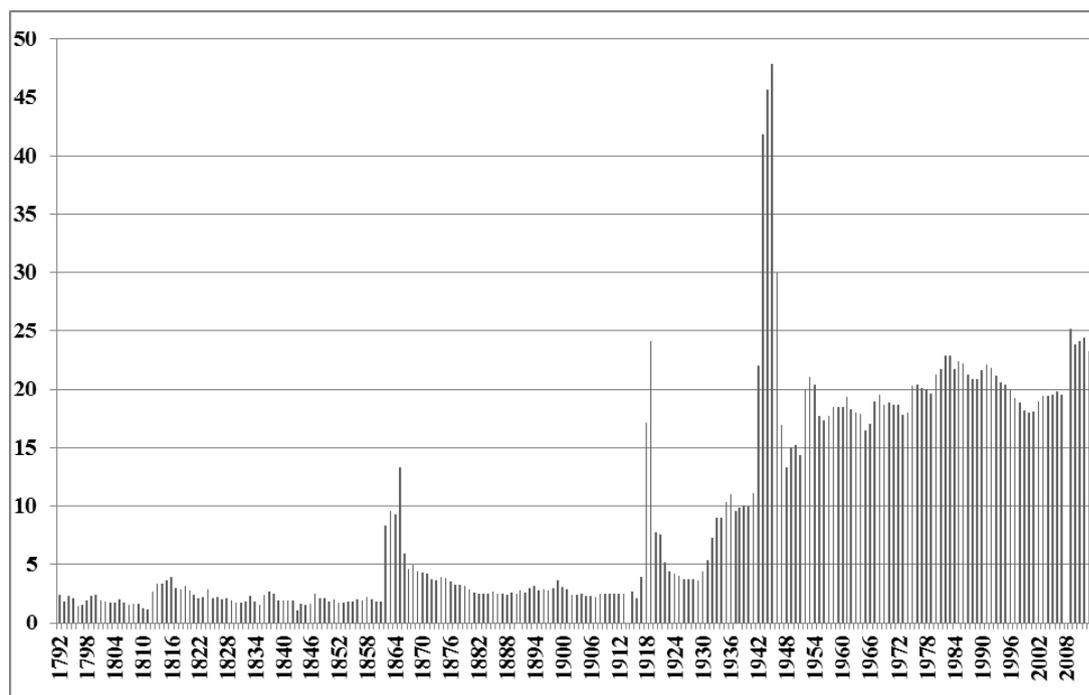
Second, it often overlooks the process of historical evolution of the US federation, which is much more centralized today than it was at the beginning of 20<sup>th</sup> century, not saying about the first half of 19<sup>th</sup> century, including its fiscal dimension (Graph 1). Until the beginning of the 20<sup>th</sup> century, the US federal budget amounted to 2-3% of GDP in peacetime. However, unlike the EU budget, it was concentrated on the provision of typical federal public goods such as general government services and national defense, with almost no redistribution and transfers. It started to grow substantially, including large-scale redistribution schemes, only after the Great Depression in the 1930s.

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<sup>3</sup> The examples of such analyses are provided by Berglof et al. (2003) and Wyplosz (2007; 2014)

<sup>4</sup> In fact, the EU is an institutional hybrid that merges characteristics of federation, confederation and international organization of independent states – see Dabrowski (2010).

Graph 1: US total federal spending as a % of GDP, 1792-2013



Source: [http://www.usgovernmentspending.com/spending\\_chart\\_1792\\_2013USp\\_13s1li011mcn\\_F0f\\_Spending\\_In\\_20th\\_Century](http://www.usgovernmentspending.com/spending_chart_1792_2013USp_13s1li011mcn_F0f_Spending_In_20th_Century)

Third, it disregards other historical and contemporary experiences of monetary unions, heterogeneous in their economic and political architecture and operational details (see e.g., Cohen, 2008; Deo, Donovan & Hatheway, 2011).

Indeed, going beyond a simple comparison of the EMU with the US, and looking for other historical and contemporary cases of monetary unions provides us with a mixed picture.

First observation relates to the fact that most historically known common currency areas (CCAs) have matched with the territory of sovereign states, either unitary or federal. Furthermore, most historical episodes of monetary unification followed political unification, which was in most cases involuntary, being the result of war, conquest, colonization, etc.<sup>5</sup> Thus, it should not be surprising that in such cases monetary union goes hand-by-hand with fiscal union: both are results of the same exogenous factor, i.e., political unification.

The EMU is different from most of those CCAs not only as a voluntary union but also because the degree of its political integration is limited (see Section 2.2.2). For this reason, it makes sense to compare the EMU not only with the monetary unions of federal states but also with voluntary monetary unions of sovereign states. We mean cases when a common currency and common central bank are not accompanied by a meaningful delegation of political sovereignty in other areas (like fiscal policy) to a supranational entity and building a political superstructure.

The 19<sup>th</sup> century examples of such monetary unions involved the Latin Monetary Union, Scandinavian Monetary Union and German Monetary Union (prior to German political unification in 1871). Due to technical specifics of monetary systems based on metallic standards, they concentrated on unification of gold and silver content of national coins and their free circulation across unions' member states (Cohen, 2008). The first two unions involved no political and other forms of integration, while the German Monetary Union was associated by a custom union.

<sup>5</sup> This historical observation also relates partly to the US and process of its territorial formation in the 19<sup>th</sup> century.

Two largest contemporary monetary unions outside Europe, the WAEMU and CEMAC, have virtually no political or fiscal integration but they have used a common currency (the CFA franc) since 1945, i.e., for 70 years. Only at the end of the 1990s did member countries of both monetary unions start to develop other segments of economic integration, i.e., custom unions, common markets and some soft forms of supranational macroeconomic policy coordination and fiscal surveillance, following the EU/EMU experience. However, the pace of those integration processes is rather slow, especially in the case of CEMAC.

Nevertheless, both monetary unions have proved sustainable so far in spite of numerous asymmetric shocks (see IMF, 2013 for a contemporary analysis of the WAEMU challenges), divergent macroeconomic trends (see Annex 1), violent political conflicts (both internal and regional), limited trade and financial integration, etc.

Other contemporary examples of monetary unions with no or weak political integration components include the ECCU and the Common Monetary Area in Southern Africa.

If we use a broader definition of monetary union by including permanently fixed exchange rate regimes (against other currency or common metallic standard – see Section 2.2.1), we obtain more cases in which monetary ‘federalism’ has not been accompanied by the political and fiscal one. This concerns, in first instance, the period of the international gold standard in the second half of the 19<sup>th</sup> century and the beginning of the 20<sup>th</sup> century, when most independent (and sometimes politically antagonistic) countries shared the same monetary rules and, in fact, remained in a quasi-monetary union (see Eichengreen, 1998; Cesarano, 2009).

## 2.5. Benefits, costs and limits of deeper fiscal integration

Now we will turn to discussion on potential net benefits of deeper fiscal integration. Following analysis in Section 2.3.2, we will look for these proposals from the perspective of the theory of fiscal federalism and divide them into measures, which can increase sustainability of a common currency and those that help increasing returns to scale or address cross-border externalities in other policy areas.

In the first group, there are three potential arguments in favor of closer fiscal integration in Europe, namely (i) building the banking and capital market union, (ii) conducting countercyclical fiscal policy and (iii) cushioning asymmetric shocks.

In the light of the recent global and European financial crisis experience, unifying financial market regulations and supervision, building the pan-European deposit insurance and crisis resolution mechanisms (to deal with potential bank failures) can provide obvious benefits for the entire EMU, EU and global economy (due to size and importance of the European financial industry). Most importantly, it will facilitate completing the single market for financial services. Otherwise, as long as regulatory and supervisory power and fiscal responsibility for crisis resolution remain in national hands (even if banks operate in more than one EU member state), the incomplete single market will face a continuous danger of fragmentation and renationalization, especially in a time of financial distress (see Kumm, 2013). Other positive externalities involve eliminating cross-border regulatory arbitrage and containing danger of cross-border financial contagion. On the other hand, such integration will lead to greater centralization of public resources at the European level as result of launching the European Deposit Insurance Scheme and the Single Resolution Fund.

By the way, the presence of large and sophisticated financial sector with cross-border operations seems to be the main feature, which distinguishes the EMU from other contemporary monetary unions of sovereign states (see Aizenman, 2013 and Wyplosz, 2015 on the role of financial integration in ensuring sustainability of the Euro).

Some authors (e.g. De Grauwe, 2006; Wolff, 2012, Cottarelli, 2012b) also suggest conducting supranational countercyclical fiscal policy based on the findings in fiscal federalism’s literature, which tend to assign this function to the federal level (see Oates, 1999; Begg, 2009; Bordo et al, 2011). Leaving aside the discussion on the effectiveness of countercyclical fiscal measures (especially discretionary ones) in smoothing the business cycle in an open economy and against various political traps (Dabrowski, 2012b), one may agree that they have more of a chance to work at the supranational level than the national level due to collective action problem, the risk of free riding and cross border ‘leakages’ of demand (Dabrowski, 2010). On the other hand, it would require building a much bigger fiscal capacity at the European level (probably in the range of at least of 10% of the Union’s GDP), including far-going tax schemes, social transfers and other expenditure responsibilities.

Not only is such a far-going fiscal centralization politically unrealistic in a foreseeable future, even within the EMU only (see below), but it may also be economically dysfunctional. First, it can contradict the basic principle of fiscal federalism, i.e. assigning responsibilities to the level of government, which can most effectively carry out a given task. Taking into consideration the internal political, economic, social and cultural diversity of the EU, the optimal degree of its fiscal centralization may be lower than in other ‘mature’ and more homogenous federal states. Second, taking into consideration the remaining huge productivity differences across the EU, centralization of social and income policies (which usually stays behind the substantial size of federal budgets and their countercyclical capacity) may lead to the excessive convergence of labor and social costs<sup>6</sup> and, as a result, make the EU labor market even more rigid than it is now.

For example, Wolff (2012), who supports the idea of moving part of the countercyclical fiscal policy from the national to the Eurozone level, including the creation of a Eurozone budget in the range of 2% of GDP, recognizes the risks associated with building a single unemployment insurance system within the Eurozone. Dullien & Fichtner (2013) also see some risks but they strongly advocate such a common unemployment insurance scheme. Beblavy et al. (2015) propose introduction of EU-wide reinsurance scheme for national unemployment insurance systems.

In most historical cases, the countercyclical role of the federal budget has come as a result of the prior centralization of various responsibilities: public pension systems, unemployment benefits, deposit insurance, federal infrastructure projects, and general public services (which include defense, public order, foreign policy, public health, education, justice administration, federal taxation, etc.), rather than building explicitly countercyclical fiscal facilities.

Wolff (2012) and the European Commission (2012) suggest a controversial idea of building a centralized Eurozone fund which would provide member states with automatic but temporary fiscal transfers in the case of adverse idiosyncratic shocks (repaid in ‘good’ times), a kind of a countercyclical insurance mechanism. The first question is how often EMU economies experience asymmetric business cycles and suffer from idiosyncratic supply shocks (see Section 2.3.1). Second, if transfers are to be neutral over the medium term as expected in those proposals it means an implicit assumption of a perfect regularity and symmetry of business cycles, which is far from the contemporary reality. Third, it underestimates difficulties with the *ex ante* identification of a given phase of the business cycle and the character of the shock (supply vs. demand, asymmetric vs. symmetric). Finally, it ignores the political economy and politics of any such redistribution mechanism, which most likely will make transfers permanent rather than temporary and repayable.

Gros (2012) argues that redistribution mechanisms in federal states such as the US may help decrease income disparities between regions rather than cushion asymmetric shocks. In his opinion, the US banking union seems to be the most effective instrument for addressing asymmetric shocks. His opinion can be interpreted as assigning the primary role in cushioning asymmetric shocks to mobility of private capital and labor rather than cross-territorial fiscal transfers (see Section 2.3.1).

If we go beyond an economic policy sphere, we can find more cases of potential benefits of centralization. This may relate to the EU common defense and security policy (see Briani, 2013), the protection of external borders, common consular services, environmental policy and many others.

However, the economic rationale for the centralization of new functions will always have to be confronted with political considerations such as national sovereignty concerns (Begg, 2009; Wyplosz, 2014, 2015), the interests of the incumbents at the national level and a limited appetite for cross-border fiscal redistribution<sup>7</sup>. As a result, the EU has been built around the principle of subsidiarity enshrined in Article 5 of the Treaty on European Union (TEU)<sup>8</sup>. According to this principle, the functions of higher levels of government should be as limited as possible and should be subsidiary to those of lower levels (see Mortensen, 2004).

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<sup>6</sup> Experience of German reunification in 1990s when labor costs in East Germany rapidly converged to the West German level (without a sufficient increase in productivity level in the East) and led to a high unemployment rate may serve as a warning example (see von Hagen & Strauch, 2001).

<sup>7</sup> Buitier (2013) argues that a similar reluctance to cross-regional redistribution is observed within national states in Europe, resulting in secessionist tendencies in some of them.

<sup>8</sup> In this study, we use the current numbering of articles in both the TEU and the ‘sister’ Treaty of the Functioning of the European Union (TFEU) in their consolidated versions (after entering into force of the Lisbon Treaty).

## 2.6. Conclusions

Summing up this part of our study, monetary unions between sovereign states or within relatively loose political federations or confederations are not a new phenomenon and may be relatively sustainable if not affected by major political shocks such as the World War I. This means that the EMU is not as unique a historical case as suggested by some authors (e.g., Bordo et al, 2011) or official documents (e.g., European Commission, 2012) and it makes sense to learn from the above-mentioned experiences (instead of limiting comparison to the US). These experiences tell us that monetary integration does not necessarily must be accompanied by fiscal and deeper political integration, or even – by trade and market integration (however, the absence of the latter limits major potential benefit from a monetary union, i.e. lower transaction costs).

If we compare the EMU with other past and contemporary monetary unions of sovereign states, it does not look so bad from the point of view of its institutional architecture, complexity and economic characteristics. It is accompanied by the advanced (although still incomplete) Single Market of goods, services, capital and labor which has led to increasing level of trade and investment integration, increasing cross-country labor mobility (Wyplosz, 2015) and high degree of synchronization of business cycles. This means it meets basic economic precondition of its effective functioning as determined by the OCA theory. Furthermore, it is the first historical case when the OCA theory was taken into account during the process of setting the CCA (apart from political goals and considerations). The EMU is also accompanied by a partial fiscal and political union.

In response to the recent financial crisis, some important elements of fiscal union have been redesigned, further developed or added. This concerns building up the Banking Union (see Section 2.5), sovereign debt resolution mechanism and bailing out facilities within the Eurozone, overhaul of fiscal discipline mechanism (see Section 4.2.2) and strengthening mechanisms of macroeconomic policy coordination (see Section 3.1).

### 3. Interrelation between monetary integration and macroeconomic policy coordination

In this part of the study, we will assess the new regulatory framework of the Macroeconomic Imbalance Procedure (MIP) and explore arguments in favor of closer coordination and integration of member states' macroeconomic policies (apart from fiscal policies which are subject of separate regulation and which are discussed in Section 4) from the perspective of sustainability of a common currency. This will be followed by an analysis of the content of this surveillance. Finally, given importance of the so-called imbalances, in particular, current account imbalances in the practical implementation of the MIP and their supposed responsibility for causing macroeconomic instability within the Eurozone, we will discuss their role in the world of unrestricted capital movement.

#### 3.1. The new regulatory framework

The European debt and financial crisis has led to strengthening mechanisms of macroeconomic policy coordination and surveillance within the EU and EMU, including the new institution of MIP, under which current account imbalances of member states and factors and policies, which determine them and member states' competitiveness, are subject of regular monitoring, corrective actions and even potential financial sanctions<sup>9</sup>. The MIP and accompanying Excessive Imbalance Procedure (EIP) have been determined by the two EU regulations:

- Regulation (EU) No 1176/2011 of the European Parliament and of the Council of 16 November 2011 on the prevention and correction of macroeconomic imbalances (which applies to all EU member states)
- Regulation (EU) No 1174/2011 of the European Parliament and of the Council of 16 November 2011 on enforcement measures to correct excessive macroeconomic imbalances in the euro area (which applies to EMU members only)

and their practical implementation in the form of the MIP Scoreboard, Alert Mechanism Reports (AMR) and In-Depth Reviews (IDR). Formally, the MIP procedure refers to the Article 121 of the TFEU.

#### 3.2. Does the common currency require macroeconomic policy coordination?

The OCA theory says nothing about 'macroeconomic imbalances' as the precondition of smooth functioning of a CCA. Current-account imbalances can exist as far as they are sustainable, i.e., are matched by the respective capital account imbalances with an opposite sign. Deterioration of current account (beyond possibility of its financing) can result from asymmetric real shocks but it does not represent asymmetric shock itself (see discussion in Section 2.3.1). Thus, it is symptom of problem rather than its cause. What does really matter, according to the OCA theory, it is factor mobility and potential room for fiscal cushioning.

When we look at the historical and contemporary experience of monetary unions of largely sovereign states, we will not find cases or even attempts of this kind of macroeconomic policy coordination. As we mentioned earlier (Section 2.4), these other CCAs have not advanced other forms of economic integration apart from partial trade and capital account openness (even that has not been always the case, for example, in the WAEMU or CEMAC).

In case of the EU and, in particular of the Eurozone, the depth and sophistication of already accomplished degree of economic integration may require some sort of macroeconomic policy coordination<sup>10</sup> or even further delegation of national competences to the EU level. Experience of the recent global and European financial crisis clearly demonstrates that economic problems in one, even relatively small country can spread rapidly to

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<sup>9</sup> See [http://ec.europa.eu/economy\\_finance/economic\\_governance/macroeconomic\\_imbalance\\_procedure/index\\_en.htm](http://ec.europa.eu/economy_finance/economic_governance/macroeconomic_imbalance_procedure/index_en.htm)

<sup>10</sup> Article 121.1 of the TFEU says that 'Member States shall regard their economic policies as a matter of common concern [...]'

all other member states (contagion effect). Besides, there is a huge negative potential of various beggar-thy-neighbor policies, not necessarily explicitly violating the *acquis communautaire*. That is, even if a national economic policy addresses strictly domestic issues (examples of national labor market or social policy regulations, housing policies, etc.) its potentially negative effects (in case of their wrong design) will affect eventually the entire EU (see Cottarelli, 2012a on idiosyncratic non-fiscal policies). Thus, the pros argument is similar to that in favor of Banking Union and its complementarity to the common currency area (see Section 2.5). However, one must confront it with other considerations.

First, the presented arguments in favor of closer coordination of member states' economic policies and their monitoring apply not only to the Eurozone but also to the entire EU as a deeply integrated economic block. This is probably the reason of duality of the MIP: its preventive arm (Regulation (EU) No 1176/2011) applies to all member states, while the corrective arm (Regulation (EU) No 1174/2011) concerns the Eurozone members.

Second, there is the question how this new form of surveillance relates to division of competences between the national and Union levels. The analysis of both AMR (see European Commission, 2014b) and IDR (see European Commission, 2014a) suggests the potential collision: the content of monitoring concerns areas, which remain in the sphere of national competence, for example, the entire area of labor market and social policy regulation. This makes the MIP, and even more EIP intrusive from the point of view of the national sovereignty, similarly to the Stability and Growth Pact (SGP) and Excessive Deficit Procedure (EDP) in case of fiscal rules (see Section 4). As result, application of the MIP may not be welcomed by national policymakers, unless the European Commission limits its activity to general assessment and 'soft' guidelines. However, the 'Five-Presidents Report' (Juncker et al. 2015) suggests a further increase in level of intrusiveness of the MIP and European Semester with the aim to build 'genuine Economic Union' (without changes in the TFEU, which would lead to centralization of competencies in the respective policy areas).

Third, the content of monitoring (MIP Scoreboard, AMR, and IDR) refers to variables, which remain largely out of control by individual governments, especially in the economy open to free movement of goods, services, labor and capital. For example, looking into the MIP Scoreboard indicators, only general government gross debt to GDP indicator remains controllable by a national government. Among others, labor unit costs, unemployment rate, and perhaps private sector credit flows can be influenced, to some degree, by national government policies although question on the strength of their impact, content of corrective measures, and time-lag between their adoption and results remains debatable.

One of possible interpretations of the MIP Scoreboard is that its actual goal is not monitoring these concrete indicators but rather influencing member states' microeconomic and structural policies, which may have impact on those indicators<sup>11</sup>. However, if this is the case, then we come back to the question of the MIP intrusiveness (from the point of view of national sovereignty) and impact of the mentioned policies on concrete indicators.

Fourth, conceptual framework of the MIP raises many questions. In particular, the emphasis on imbalances (especially current account ones) seems to disregard the realities of deeply integrated Single Market with unrestricted capital movement (see Section 3.3) and single currency (in case of Eurozone). Other indicators used in the MIP raise doubts from the point of view of international specialization of individual national economies (for example, some of them serve as the international financial centers for the entire EU or even outside world, so they can record higher rate of growth of credit to private sector). The concrete reference values, which determine the zones of vulnerability, can also raise doubts.

Fifth, there is also question of enforceability of the MIP procedure. On the paper, this procedure is backed by the potential financial sanctions (under the EIP). However, the experience of the SGP and EDP under which sanctions have never been implemented despite serious violation of fiscal rules by individual countries (see Section 4.3), suggests that the EIP enforcement may face similar problems. If substantial number of member states (including the biggest ones) is recorded by the AMR and IDR as suffering from various kinds of 'imbalances' it will be hard to build a political coalition to support corrective measures (backed by sanctions) against any individual country. In addition, the conceptual and methodological doubts and sovereignty concerns mentioned above will not work in favor of enforceability of the MIP. They will leave great room for arbitrary judgment and, therefore, for political bargaining.

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<sup>11</sup> Such an interpretation finds justification in the proposals offered by the Five-Presidents Report (see Juncker et al., 2015)

### 3.2. Must every country remain in balance? Critical comments on the role of current account imbalances

As we discussed in Section 3.2, the conceptual background of the MIP and EIP raises several questions. First, the meaning of macroeconomic imbalance has not been clearly defined in the EU legislation. Based on the content of the MIP Scoreboard, AMR, IDR and Commission's comments, one can find a current account imbalance as the central variable of the entire surveillance process and operational equivalent of macroeconomic imbalance. However, this means attempt to control the variable, which is well beyond direct policy influence in a world of free capital movement, especially within a CCA.

#### 3.3.1. Traditional approach to balance-of-payments analysis

This role assigned to current account imbalances in the MIP seems to reflect a traditional balance-of-payment analytical framework based on realities of largely closed (or only partly open) economies with a limited role of cross-border private capital flows. In the closed economies, national governments had an ability to influence saving and investment decisions of domestic economic agents.

The 'traditional' analysis usually started from domestic factors of competitiveness, in the first instance, labor unit costs denominated in foreign currency. These factors determined the trade and current account balances. Capital account transactions had to counterbalance the current account. If a country ran a current account deficit, it needed foreign credit (private or official), foreign direct investment (FDI) or other form of capital inflow to finance that deficit. If it ran a current account surplus the latter had to be absorbed in the form of capital account transaction with the opposite sign, i.e., through various forms of capital exports/ outflows or increasing official reserves (which is also a form of capital export).

Each kind of net capital inflows (including FDI) led to the accumulation of a country's external liabilities (negative net international investment position, IIP), which according to 'traditional' framework (i) could not grow indefinitely, (ii) had to be repaid at some point, (iii) and the higher they were, the more vulnerable the country's external position was.

If a current account balance became unsustainable, given difficulties in conducting counterbalancing capital account transactions, policy adjustment was needed. The adjustment might be implemented through the instruments of exchange rate policy (devaluation or revaluation of domestic currency), trade policy, monetary and fiscal policies (which determined the level of domestic absorption) and others.

Summing up, in a world of restricted capital mobility it was the current account balance, which determined capital account flows. In a world of free capital mobility, however, the reverse causality dominates: net capital flows (at least their private component) have a largely exogenous character and the current account balance must adapt itself to changes in the capital account.

#### 3.3.2. Modified approach to balance-of-payments analysis

Living in a world of largely unrestricted capital movement requires a new attitude to current account imbalances.

The 'traditional' approach (see Section 3.3.1) was based on the implicit assumption that capital ownership residency has a fixed character (see Dabrowski, 2008). This meant that capital invested in country A, financed by savings coming from country B, would 'belong' to the latter, including its right to repatriate factor income (interest or dividend) and - eventually - the invested capital stock. Such assumptions might be justified in a world of restricted capital movement, which, in turn, was reflected in the empirical phenomenon of the 'home country bias' in investing gross national saving as described by Feldstein & Horioka (1980).

In a world of largely unrestricted capital movements major sources of capital do not have a country of origin, given the transnational character of major corporations, financial institutions and investment funds, even if they invest on behalf of residents of concrete countries. In addition, with the free movement of people, physical persons (especially wealthy ones) may easily change their country of residence (domicile), moving together with their accumulated savings. This is even easier within the Single European Market.

Second, private investors seek the highest rate of return in their investment/ re-investment decisions, regardless their country of residence. Each individual rate of return consists of two major components: (i) a country-related component reflecting a country's investment climate and (ii) a project-related component.

However, if the investment climate deteriorates (or investors fear such deterioration) and the expected rate of return in country A becomes lower than that of country B the direction of capital movement may change. Such change will affect not only 'foreign' capital (that from country B) but also domestic residents (those from country A). This means a capital importer (country A) is not immunized from the danger of capital outflows but such a danger originates from changes in the country-related component of the expected rate of return (comparing to other countries) rather than from the non-resident origin of the invested capital.

Looking at the problem of cross-country current account imbalances from the 'supply side' perspective there are countries which for various historical, demographic, institutional and other reasons are able to generate a systematically higher rate of national saving than others, in excess of their own investment needs. Unrestricted capital movement and global financial market enable moving this excess saving to countries/ locations where they can be invested in the most efficient way to the benefit of both savers and investors.

Finally, moving part of saving from high-income economies to middle- or low-income economies facilitates the process of catching-up growth and economic convergence. Requesting less developed economies to 'stay in balance', i.e., having balanced current account (or run only small current account deficit) means denying them one of the potential sources of financing their economic convergence.

### 3.3.3. Assessment of current account imbalances

Traditional approach to balance-of-payments analysis often leads to paradoxical conclusions: countries considered by international investors as business friendly, and therefore attracting large amounts of private investment (and consequently running high current account deficits and large negative IIP) are assessed as conducting unsustainable policies and 'overheated'. On the contrary, countries characterized by poor business climate, which are not able to attract net private capital inflows or even suffer from net capital outflows (of both residents and non-residents), record either balanced or positive current accounts and are considered as macroeconomically 'healthy'<sup>12</sup>.

However, one cannot say that current account imbalances have become totally irrelevant. As long as a capital-importing country has its own currency and sovereign monetary and fiscal policies, at some point (for example, triggered by global financial shock or regional contagion) its current account deficit may start to be considered by investors as too high and its liabilities in foreign currency unsustainable. This may cause its exchange rate risk premium to increase and its expected rate of return to decrease. These developments may trigger a sudden outflow of capital (both resident and non-resident) and balance of payments (BoP)/ currency crisis. Thus, the current account balance and, more generally, the BoP must remain a subject of interest and concern of national economic policies in countries, which have their own currencies. Nevertheless, any concrete threshold of current account deficit (like 4% of GDP in the MIP) cannot offer a good indication of country's exchange rate risk (given other factors, which can influence risk's perception)

### 3.3.4. Current account within monetary union

In the monetary union (according to its narrow definition, i.e. currency union – see Section 2.2.1) exchange rate risk disappears. Current account imbalances between union's members become the interregional imbalances within a CCA. In federal states such as the US (which often serve as the benchmark in various discussion and comparative analyses on the EMU – see Section 2.4) they are not even computed by the national statistical systems and are not the matter of policy concerns.

Within a CCA, interregional 'current account' imbalances are matched by private and government financial flows. The size of these flows limits the size of imbalances, as in the modified approach to the balance-of-payments analysis. Given the limited role of EU budget, private capital flows play the primary role in financing such imbalances within the EMU. However, during the period of European debt and financial crisis (2010-2013) the role of public transfers from the bailout funds (EFSF, ESM) and in the form of Target2 imbalances within the Euro system (see Sinn & Wollmershaeuser, 2011; Bijlsma & Lukkezen, 2012) increased substantially.

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<sup>12</sup> Russia is the most recent example of a country in which sustainable current account surpluses have not prevented a large-scale currency crisis at the end of 2014 (see Dabrowski, 2015).

If ‘excessive’ current account imbalances pose any real threat to EU-wide macroeconomic stability or the common market, it may concern countries remaining outside the Eurozone, for example, as an excessive volatility of their currencies against the Euro. However, somewhat ironically, under the MIP non-EMU members are subject to a reduced level of surveillance (as compared to EMU members) and are free of potential financial sanctions.

### 3.3.5. Current account imbalances as potential cause of financial crises

Current account imbalances were traditional ‘suspect’ responsible for serious financial turbulence. In the early and mid-2000s, many authors (e.g., Roubini and Setser, 2005) predicted that large current account imbalances between major world economies/ regions would lead to a global BoP crisis unless they were reduced in a gradual and orderly manner. However, the 2007-2009 global financial crisis was caused by bursting housing and stock market bubbles in the US and few other countries. Current account imbalances between major economic players such as the US, the EU, China, other Asian economies and oil-producing countries neither were the primary cause of this crisis<sup>13</sup>, nor became significantly corrected as a result of this crisis.

The same kind of discussion was repeated after the European debt crisis erupted in 2010. Those who did not want to accept the most obvious diagnosis on the fiscal roots of this crisis searched for other explanations, including the BoP crisis hypothesis. However, because the Eurozone as a whole had either a balanced current account or in surplus the advocates of a BoP crisis diagnosis pointed to internal current account imbalances between EMU members (e.g., Mayer, 2011; Krugman, 2012; Sinn, 2012; the opposite opinion was presented by Wyplosz, 2013). Indeed, since 2010, the subsequent peripheral Eurozone countries in troubles suffered from capital outflows but this was the consequence of the increased risk of sovereign default and the associated perception of a possible Eurozone disintegration (which reintroduced expectation of exchange-rate risk) rather than the primary cause of the crisis (Dabrowski, 2012b).

### 3.3.6. Policy instruments to correct current account imbalances

If the current account imbalances, IIP and real exchange rate are as important as suggested by the MIP Scoreboard, how may EMU national governments influence the size and direction of private capital flows, the key exogenous factor determining a country’s external position?

Capital controls, monetary and exchange rate policies are out of the book – the Treaty bans the former, the latter are delegated to the ECB.

Fiscal policy may have some impact on the current account as it influences net national saving. However, one should take into account the offsetting effects in terms of net private financial flows. For example, fiscal contraction, which is widely considered as one of the measures to diminish current account imbalances, may not necessarily bring the expected results due to ‘crowding-in’ effects (Rostowski, 2001). Investors usually perceive successful fiscal adjustment as decreasing country risk (that is, increasing the expected rate of return) what boosts private capital inflows, thus leading to higher account deficits.

Fiscal policy may also have some microeconomic impact through various kinds of fiscal incentives and disincentives. For example, in some countries, which experienced housing market booms and busts in the 2000s, special tax incentives artificially stimulated housing investments. However, in most cases such incentives or disincentives influence the structure of capital flows rather than their total volume.

The same concerns micro-prudential financial regulation. They may have a benefit of their own by increasing the robustness of financial sector. However, their impact on capital flows may concern their structure rather than the overall volume.

Finally, macro-prudential financial regulation may have some impact on both the volume and structure of capital flows. However, in the EMU it is expected to have a Union-wide character rather than address specific policy issues in individual member states.

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<sup>13</sup> Rather they could be considered as secondary symptoms of other macroeconomic excesses such as soft monetary policy in the US and other advanced economies, or regulatory distortions related to the financial sector, housing market and so on.

The above brief review of policy instruments confirms limited potential of national policies in regulating the BoP, current account imbalances, IIP and real exchange rate within a monetary union and single market with unrestricted capital movement.

### 3.4. Conclusions

Our analysis demonstrates that the Eurozone is unique, in comparison with both federal states and monetary unions of sovereign states, in its focus on monitoring and surveillance of internal current account imbalances, IIP and real exchange rates. Federal states do not even have BoP, IIP and real exchange rate statistics of its sub-federal entities. In monetary unions of sovereign states (such as WAEMU or CEMAC) BoP or competitiveness problems remain solely the matter of national concern.

Indeed the EMU members, especially peripheral ones, suffered disruption in cross-border financial flows and danger of far-going segmentation of financial markets along national borders, during the period of European debt and financial crisis (2010-2013). They could be considered as the equivalent of typical BoP crisis. However, this crisis was not caused by excessive current account imbalances and negative IIP but by the banking and sovereign debt crisis in individual countries, which led to financial panics. This was fear of uncontrolled sovereign default in some countries and Eurozone disintegration, which caused a sudden stop in capital flows and national segmentation of financial markets. Current account imbalances prior to the crisis could serve as indicators of other macroeconomic problems (for example, credit or housing bubbles, excessive public sector borrowing requirements, etc.) rather than be responsible for the crisis.

The MIP seems to be similar, in some sense, to the IMF Article IV consultation mechanism, which origins go back to the time of Bretton Woods fixed exchange rate mechanism. However, the Bretton Woods mechanism was different from a currency union such as the EMU. It was system of fixed but adjustable exchange rates and BoP surveillance had a crucial importance for avoiding speculative attacks against individual currencies and minimizing the number of exchange rate adjustments. Furthermore, it worked in the world of largely controlled capital movements, hence national governments had more instruments directly influencing a BoP than they have now, in the world of largely unrestricted capital flows.

## 4. Fiscal discipline vs. fiscal solidarity

This part of the essay will explore arguments in favor of more strict fiscal discipline rules and fiscal solidarity mechanisms in the EU and EMU, both from the point of view of sustainability of the common currency. The link between fiscal discipline, fiscal equilibrium and currency stability seems to be well-understood and relatively well-explained in the literature. The potential positive impact of fiscal solidarity is more controversial. It may involve lower adjustment costs of a country in trouble, limiting cross-border contagion, and contagion to a financial sector. However, these potential benefits must be balanced against the risk of moral hazard and free riding behavior, which undermine fiscal discipline.

We will analyze practical experience of the EU and EMU in this sphere accumulated since adoption of the Maastricht Treaty in 1993. In addition, we will look at fiscal rules, market discipline and fiscal solidarity mechanisms in selected federal states, their impact on both fiscal and monetary stability and potential relevance of this experience for the EU and EMU.

### 4.1. The role of fiscal discipline in federal arrangements

Fiscal discipline is very important for currency stability and, more broadly, financial and macroeconomic stability in any country/ territorial entity. However, it becomes critically important within federations, confederations and closely integrated economic blocks due to a greater risk of cross-border spillovers and contagion, free riding at the cost of neighbors, and the moral hazard problem (expectation of bailout). Thus fiscal discipline should be considered an important common public good for the entire EU but even more importantly, within the EMU, due to the obvious negative impact of fiscal imbalances on currency stability (see Wyplosz, 2013).

### 4.2. Mechanism of fiscal discipline in the EU/EMU and its evolution

Fiscal discipline may be ensured by market mechanisms (danger of sovereign default) and formal fiscal rules (formal constraints), or a combination of both. In turn, fiscal rules can be divided into fiscal targets and fiscal procedures, which are either imposed by a federal center, self-imposed by a sub-federal entity, or negotiated by both (see Eyraud & Gomez Sirera, 2013).

#### 4.2.1. The original mechanism

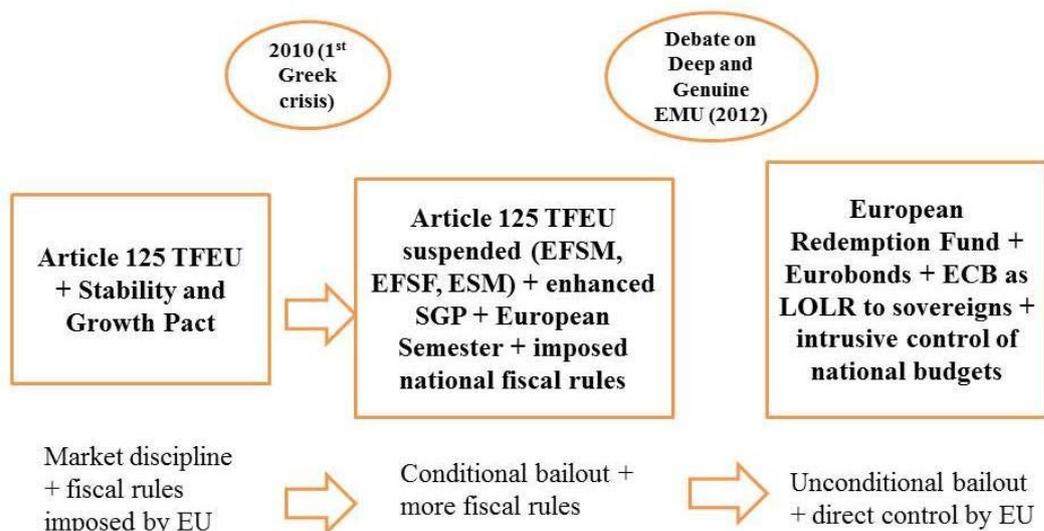
The original EU/EMU mechanism of fiscal stability as determined by the Maastricht Treaty was based on both market discipline and fiscal rules. The former was built around the 'no bail out' clause in Article 125 of the TFEU and the ban on debt monetization by the ECB (national central banks in member states which have not yet introduced the Euro) - Article 123 of the TFEU. On other hand, Article 126 of the TFEU, the accompanying Protocol No. 12 and the EU's secondary legislation, i.e., the SGP, have determined fiscal rules. They have included numeric criteria on the maximum fiscal deficit and debt level (the so-called Maastricht criteria) backed by administrative and financial sanctions for breaching them (within the EDP).

Regarding the 'no bail out' clause, financial markets have never seemed to take it seriously, as demonstrated by very low yield spreads prior to the 2008/2009 global financial crisis, in spite of big differences in the fiscal positions of individual countries. To make a fair judgment, there might be also other reasons of low spreads. For example, they could be caused by *ex ante* expectations of fiscal consolidation in countries with higher deficits and debts based on rapidly decreasing borrowing costs, the potential impact of EU fiscal rules and the impact of a lax US monetary policy which has led to abundant global liquidity (see Issing, 2009; Dabrowski, 2012b). However, these other possible interpretations do not necessarily contradict the hypothesis on the low credibility of the 'no bail out' clause.

#### 4.2.2. The modified mechanism

If financial markets doubted in credibility of the ‘no bail out’ clause they proved right because it became *de facto* suspended with the adoption of the first financial assistance package to Greece in May 2010 and building a temporary (EFSF) and then permanent (ESM) bailout facility. Before the first rescue program for Greece, in 2008-2009, the EU also provided the so-called balance-of-payment support to three non-EMU member states, Hungary, Latvia and Romania, part of which could be used for budget needs. Thus, the ‘no bail out’ principle was replaced by a policy of conditional bailout (financial assistance in exchange for a country’s commitment to fiscal adjustments and necessary reforms – see Graph 2).

Graph 2: Evolution of fiscal arrangements within the EU/EMU



Source: Author's own analysis

This fundamental change in the EU/EMU fiscal discipline mechanism can be best explained by the fear of cross-country contagion against the high and rapidly increasing sovereign indebtedness of several EU and EMU members (Table 1). The high fragility of EU banking sector impaired by the first stage of the global financial crisis (2007-2009) and having high exposure to sovereign debt of countries in trouble was another important factor, which decreased the political appetite of member states to enforce the ‘no bail out’ principle.

To compensate for circumventing the ‘no bail out’ clause, formal fiscal rules have been seriously reinforced and strengthened by the so-called Six-Pack legislation in December 2011, Two-Pack legislation in May 2013 (which is addressed only to Eurozone countries) and the intergovernmental Fiscal Compact (in force since January 2013). The Six-Pack and Two-Pack legislations strengthened both the ‘preventive’ and ‘corrective’ arms of the SGP, which now include, at least formally, automatic and meaningful sanctions. Other parts of the Six-Pack oblige member states to enhance their national fiscal rules and institutions through either constitutional changes or equivalent legislation. Most of these provisions have been also included into the Fiscal Compact signed and ratified by 25 EU member states (all except the UK, Croatia and the Czech Republic; in the latter the ratification process is pending). However, for non-EMU countries a substantial part of the Treaty provisions has a non-binding character.

Summing up, after 2010 the EU and EMU have moved from a ‘no bail out’ principle to a conditional bail out policy with a parallel attempt to strengthen formal fiscal rules.

Table 1: General government gross public debt, in % of GDP, 2007-2013

Country	2007	2008	2009	2010	2011	2012	2013
EU	58.9	63.2	73.7	79.4	82.0	86.1	88.0
Eurozone	66.5	70.3	80.2	85.9	88.3	92.9	95.2
Belgium	84.0	89.2	96.6	96.6	99.2	101.1	101.2
Bulgaria	18.6	15.5	15.6	14.9	15.4	17.5	16.4
Croatia	32.9	29.3	35.8	42.6	47.4	54.2	60.2
Cyprus	58.8	48.9	58.5	61.3	71.5	86.6	111.5
Czech Rep.	27.9	28.7	34.6	38.4	41.4	46.2	46.0
Denmark	27.1	33.4	40.7	42.8	46.4	45.4	44.5
Estonia	3.6	4.5	7.0	6.5	6.1	9.7	9.8
Finland	33.9	32.5	41.5	46.6	47.3	51.8	54.7
France	63.2	67.0	78.0	80.8	84.4	88.7	91.8
Germany	65.2	66.8	74.6	82.5	80.0	81.0	78.4
Greece	107.2	112.9	129.7	148.3	170.3	157.2	175.1
Hungary	67.0	73.0	79.8	82.1	82.1	79.8	79.3
Ireland	24.0	42.6	62.2	87.4	98.9	111.4	116.1
Italy	103.3	106.1	116.4	119.3	120.7	127.0	132.5
Latvia	7.8	17.2	32.9	39.7	37.5	36.4	35.0
Lithuania	16.8	15.5	29.5	38.3	39.2	41.0	39.3
Luxembourg	6.7	14.4	15.5	19.5	18.7	21.7	23.1
Malta	60.7	60.9	66.5	65.9	68.8	70.5	72.2
Netherlands	42.5	54.7	56.4	59.0	61.3	66.5	68.6
Poland	45.0	47.1	50.9	54.9	56.2	55.6	57.1
Portugal	68.4	71.7	83.7	94.0	108.2	124.1	128.9
Romania	12.7	13.6	23.8	31.1	34.3	38.2	39.4
Slovakia	29.4	27.9	35.6	41.0	43.6	52.7	55.4
Slovenia	22.7	21.6	34.4	37.9	46.2	53.3	70.0
Spain	36.3	40.2	54.0	61.7	70.5	85.9	93.9
Sweden	40.2	38.8	42.6	39.4	38.7	38.3	40.5
UK	43.7	51.9	67.1	78.5	84.3	89.1	90.6

Source: IMF World Economic Outlook database, October 2014

#### 4.3. Continuous problems with rules' enforcement

In practice, however, fiscal rules imposed by the TFEU and SGP were frequently breached (sometimes by a large margin) and no financial sanctions were ever adopted. Even in the short one-year testing period prior to admission to the EMU, when each candidate country had to demonstrate its compliance with the Maastricht criteria, the rules only partially worked. Most EMU candidates missed either the debt or the deficit criterion, or both, but were nevertheless admitted. This was the case with Austria, Belgium, Cyprus, France, Greece, Ireland, Italy, Malta, Netherlands, Portugal and Spain.

Not surprisingly, after adopting the Euro, member states' incentives to follow the EU's fiscal rules became even weaker. As many of them breached the rules in the early 2000s, including the three biggest EMU members (France, Germany and Italy – see Table 2), no effective enforcement mechanism of the SGP could be launched. Furthermore, the coalition of 'bad boys' led to a substantial softening of SGP in 2005 by adding several exemptions which could justify non-compliance with the TFEU and SGP. As result, high deficits and a rapidly growing public debt burden (Tables 1 and 2) became the norm. Since the end of 2009, several EMU member states (Greece, Ireland, Portugal, Spain, Italy, and Cyprus) started to face danger of sovereign insolvency.

Despite their formal strengthening in 2011-2013, enforcement of the reformed fiscal rules in practice remains problematic (as seen in Tables 1 and 2) for a number of reasons.

Table 2: General government net lending/borrowing, in % of GDP, 1999-2014

Country	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	No of years with deficit > 3%
Austria	-2.6	-2.1	-0.6	-1.3	-1.7	-4.8	-2.5	-2.5	-1.3	-1.5	-5.3	-4.5	-2.6	-2.3	-1.5	-3.3	4
Belgium	-0.6	-0.1	0.2	0.1	-1.8	-0.2	-2.6	0.2	0.0	-1.1	-5.5	-4.0	-3.9	-4.1	-2.9	-3.2	5
Bulgaria	n/a	-0.6	-0.6	-0.6	0.0	1.6	2.2	3.3	3.1	2.8	-0.9	-3.9	-1.9	-0.4	-1.8	-3.7	2
Croatia	n/a	n/a	n/a	-4.5	-4.6	-5.1	-3.7	-3.4	-2.5	-2.7	-5.9	-6.0	-7.7	-5.6	-5.2	-5.0	11
Cyprus	-4.1	-2.2	-2.1	-4.2	-6.0	-3.8	-2.3	-1.1	3.2	0.9	-5.6	-4.8	-5.8	-5.8	-4.3	-0.1	9
Czech Rep.	-3.4	-3.5	-5.3	-6.3	-6.4	-2.7	-3.1	-2.3	-0.7	-2.1	-5.5	-4.5	-3.0	-4.0	-1.4	-1.0	9
Denmark	0.9	1.9	1.1	0.0	-0.1	2.1	5.0	5.0	5.0	3.2	-2.8	-2.7	-2.1	-3.7	-1.1	1.8	1
Estonia	-3.6	-0.2	-0.1	0.3	1.7	1.6	1.6	2.4	2.4	-2.9	-1.9	0.2	1.0	-0.3	-0.5	0.4	1
Finland	1.6	6.7	4.9	4.0	2.3	2.2	2.6	3.9	5.1	4.2	-2.5	-2.5	-1.0	-2.1	-2.3	-2.7	0
France	-1.6	-1.3	-1.4	-3.1	-3.9	-3.5	-3.2	-2.3	-2.5	-3.2	-7.2	-6.8	-5.1	-4.9	-4.1	-4.2	11
Germany	-1.6	1.1	-3.0	-3.7	-4.0	-3.6	-3.2	-1.6	0.2	-0.1	-3.0	-4.0	-0.8	0.1	0.1	0.6	5
Greece	-3.0	-3.6	-4.3	-4.7	-5.5	-7.1	-5.5	-6.1	-6.7	-9.9	-15.2	-11.1	-10.1	-6.3	-2.8	-2.7	13
Hungary	-2.6	-4.3	-3.9	-8.7	-7.1	-6.4	-7.7	-9.2	-5.0	-3.6	-4.5	-4.5	-5.2	-2.3	-2.4	-2.6	12
Ireland	2.4	4.8	0.9	-0.3	0.4	1.4	1.6	2.8	0.2	-7.0	-13.9	-32.4	-12.6	-8.0	-5.7	-3.9	7
Italy	-1.8	-1.3	-3.4	-3.1	-3.4	-3.6	-4.2	-3.6	-1.5	-2.7	-5.3	-4.2	-3.5	-3.0	-2.9	-3.0	9
Latvia	-3.5	-2.5	-2.0	-2.5	-1.6	-1.0	-1.0	-0.5	0.6	-7.1	-7.7	-7.3	-3.2	0.1	-1.2	-1.7	5
Lithuania	n/a	-4.0	-3.6	-1.8	-1.3	-1.5	-0.5	-0.4	-1.0	-3.3	-9.3	-6.9	-9.0	-3.2	-2.6	-0.7	7
Luxembourg	3.6	5.7	6.0	2.3	0.6	-1.0	0.2	1.4	4.2	3.3	-0.5	-0.6	0.3	0.1	0.6	0.5	0
Malta	n/a	-5.8	-6.5	-5.7	-9.1	-4.4	-2.7	-2.6	-2.3	-4.2	-3.3	-3.3	-2.6	-3.6	-2.7	-2.2	9
Netherlands	0.3	1.9	-0.4	-2.1	-3.0	-1.8	-0.3	0.2	0.2	0.2	-5.5	-5.0	-4.3	-4.0	-2.3	-2.3	4
Poland	-2.3	-3.0	-5.3	-5.0	-6.2	-5.4	-4.0	-4.0	-2.1	-3.6	-7.2	-7.6	-4.9	-3.7	-4.0	-3.5	13
Portugal	-3.0	-3.2	-4.8	-3.3	-4.4	-6.2	-6.2	-2.0	-3.0	-3.8	-9.8	-11.2	-7.4	-5.6	-4.8	-4.5	13
Romania	n/a	-4.0	-3.2	-2.6	-2.2	-3.3	-0.7	-1.3	-3.1	-4.7	-7.1	-6.3	-4.2	-2.5	-2.5	-1.9	8
Slovakia	-7.3	-12.1	-6.4	-8.1	-2.7	-2.3	-2.9	-3.6	-1.9	-2.4	-7.9	-7.5	-4.1	-4.2	-2.6	-3.0	9
Slovenia	-0.6	-1.2	-1.2	-1.4	-1.3	-1.3	-1.0	-0.8	0.3	-0.3	-5.4	-5.2	-5.5	-3.1	-13.8	-5.8	6
Spain	-1.5	-1.0	-0.5	-0.4	-0.4	0.0	1.2	2.2	2.0	-4.4	-11.0	-9.4	-9.4	-10.3	-6.8	-5.8	7
Sweden	0.8	3.4	1.5	-1.4	-1.2	0.4	1.9	2.1	3.4	2.1	-0.9	0.0	0.0	-0.7	-1.4	-2.1	0
UK	0.8	1.2	0.4	-2.1	-3.4	-3.6	-3.5	-2.9	-3.0	-5.1	-10.8	-9.7	-7.6	-7.8	-5.7	-5.7	10
<b>No. of countries with deficit &gt;3%</b>	<b>5</b>	<b>8</b>	<b>10</b>	<b>12</b>	<b>12</b>	<b>13</b>	<b>10</b>	<b>6</b>	<b>3</b>	<b>12</b>	<b>21</b>	<b>23</b>	<b>18</b>	<b>17</b>	<b>9</b>	<b>11</b>	

Notes: yellow field - IMF staff estimation; red font - GG deficit exceeding 3% of GDP

Source: IMF World Economic Outlook database, April 2015

First, the SGP provisions continue to contain numerous exemptions and ambiguities related, in first instance, to the *ex-ante* estimation of potential output and other characteristics of the business cycle. For obvious bargaining reasons, national governments are interested to present the European Commission higher estimates of potential output, optimistic projections of real and nominal GDP, etc.

Second, several member states continue to be subject to the EDP even if their number decreased to 11 at the end of 2014 (between 2009 and 2012, it frequently exceeded 20). Several countries were subject of EDP for five or more years (in case of Hungary for nine years). Most countries, which managed to outgo the EDP, remain in the risk zone. Only Estonia and Sweden never entered this procedure<sup>14</sup>.

Between 1999, i.e., launching the Euro project and SGP, and 2014 only three countries – Finland, Luxembourg and Sweden - never had general government deficit exceeding 3% of GDP, two (Denmark and Estonia) exceeded this threshold only once, Bulgaria – twice, Austria and Netherlands – four times, Belgium and Germany – five times. Other countries recorded longer periods of non-compliance with EU the deficit target (Table 2).

<sup>14</sup> See [http://ec.europa.eu/economy\\_finance/economic\\_governance/sgp/corrective\\_arm/index\\_en.htm](http://ec.europa.eu/economy_finance/economic_governance/sgp/corrective_arm/index_en.htm)

Chronic fiscal problems in most member states make them reluctant to impose peer pressure on other ‘brothers in trouble’. In this respect, nothing has changed as compared with the pre-2008-2009 period. As a result, the Commission’s deadlines to bring countries’ fiscal positions back under the TFEU and SGP targets are frequently postponed and no financial sanctions have been adopted yet. This is a typical case of a collective action problem when there is no sufficient majority in favor of common rules enforcement.

Third, large member states thanks to their greater voting power in the EU Council and greater political and economic weight in the Union often feel themselves less constrained by common rules and deserving special treatment from others (see Sinn, 2014).

Fourth, the EU/EMU fiscal rules constrain national prerogatives in fiscal policy sphere, which is painful and hardly acceptable for national policymakers, enjoying direct mandate of their electorates and considering fiscal prerogatives as the symbol of national sovereignty (Wyplosz, 2013). In this respect, the Six-Pack legislation and Fiscal Compact make step in the right direction requiring from EU member states internalization of the EU fiscal rules into national constitutional and legal systems (see Wyplosz, 2015).

Fifth, the economic and political debate in the post 2008-2009 period has been influenced by advocates of continuous fiscal stimulus (or at least those who oppose fiscal tightening) in the name of avoiding contraction and job losses, associated with fiscal-adjustment, and returning to the pre-crisis growth dynamics. Opponents of ‘austerity’<sup>15</sup> frequently question rationale of the existing EU fiscal rules and their enforcement (see Krugman, 2012a,b, 2013; Layard, 2012; Soros, 2012). In such an intellectual atmosphere, it is not easy to build political consensus in favor of strict enforcement of the EU/EMU fiscal rules.

#### 4.4. Proposals of further changes in fiscal discipline mechanism

In its ‘Deep and Genuine EMU’ proposal, the European Commission (2012) suggested the creation of a European Redemption Fund, an idea originally developed by the German Council of Economic Advisors, which meant a step further towards a conditional bailout policy as compared to the current solutions. On the other hand, it wanted to further increase its prerogatives to monitor national budgets (currently under the European Semester procedure), including some kind of veto power in respect to national budget decisions (the instrument rarely used in federal states – see Cottarelli, 2012a). This would make EU fiscal rules increasingly intrusive and rather incompatible with the dominant political and legal architecture of the EU, i.e., a sort of limited federation or confederation.

Referring to Eyraud & Gomez Sirera’s (2013) classification of arrangements aimed at constraining fiscal policy’s room for maneuver of sub-federal entities, this would mean moving from the fiscal rules imposed by the center (the current regime) to direct controls by the center (Graph 2).

Fortunately, the ‘Five-Presidents Report’ (Juncker et al., 2015) does not follow the European Commission (2012) proposals of the European Redemption Fund and moving towards direct controls of national budget policies. Nor it mentions any other form of debt mutualisation mechanism.

However, debt mutualisation proposals and creation of a lender of last resort (LOLR) facility for governments were frequently articulated at the peak of Eurozone’s debt crisis in 2011-2012. If implemented they would mean moving from conditional to unconditional fiscal and monetary bailouts.

Debt mutualisation could be implemented by issuing Eurobonds, which would be jointly guaranteed by EMU members. The first time this proposal was analyzed publically in Giovannini et al. (2000) report. The main concern at that time was the creation of an integrated and liquid financial market within the Eurozone. The idea came back at the end of 2000s and early 2010s, in the context of the global and European financial crisis, this time with a clear intention to help countries in trouble. Some of those proposals can still be considered as a form of conditional bailout, e.g., the Blue Bond proposal of Delpla & von Weizsaecker (2010). Others represent either an unconditional bailout or a bailout with very weak conditionality (see e.g., Soros, 2012; De Grauwe, 2013).

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<sup>15</sup> The controversy ‘austerity vs. growth’ reminds very much the debate on ‘shock therapy vs. gradualism’, which accompanied post-communist transition in Central and Eastern Europe and former Soviet Union in 1990s.

The idea of Eurobonds might make sense if it served financing EU budget needs, under condition that the EU would have sufficient own revenue sources in future to pay back this debt. Currently the gap between EU spending commitments and available budget resources is financed in the form of payment arrears, i.e., by suppliers and beneficiaries of EU programs and transfers.

The LOLR proposal calls for the unlimited and unconditional commitment of the ECB to purchase debt instruments issued by Eurozone governments in case of market distress (see e.g. Bofinger & Soros, 2011; Layard, 2012).

Both proposals have been justified on the grounds of arresting the irrational behavior of financial markets, avoiding cross-country contagion, and helping governments that are temporary illiquid but fundamentally solvent survive. Again, the fear of potential contagion of over-indebted sovereigns plays the powerful role in this debate.

Unfortunately, assumptions and intentions behind those proposals are often naïve (as they tend to overestimate the fiscal sustainability of some Eurozone countries), difficult to operationalize in practice (distinguishing illiquidity from insolvency<sup>16</sup>), and largely ignore the moral hazard problem. In addition, the idea of the LOLR to governments is deeply flawed and based on dubious theoretical foundations. It confuses, intentionally or unintentionally, the governments with commercial banks (Dabrowski, 2012b). If taken seriously it means abandoning central bank independence, which has been considered as a basic institutional guarantee of price stability in the world of fiat currencies.

#### 4.5. Experience of other federations

Sadly, the debate on the EU/EMU fiscal discipline mechanism either ignores or wrongly interprets other countries' lessons, including those of the US. The US federal authorities have not bailed out any state since the 1840s and this has created a strong incentive for states to adopt fiscal discipline rules in their constitutions and secondary legislations (the federal government has imposed none of them). Similarly, counties and municipalities cannot expect a bailout from either the state or federal government. Thus, the danger of default serves as the strongest incentive to put state and municipal finances in order (Bordo et al, 2011; Henning & Kessler, 2012). The similar 'no bail out' practice governs the Canadian and Swiss federations (Bordo et al, 2011; Cottarelli, 2012b).

On the other hand, those federal states, which failed to ensure fiscal discipline of their subnational governments and provided them with bailouts, have suffered serious fiscal and monetary stability problems at a federal level. This concerns, for example, Argentina, Brazil (see Bordo et al, 2011; Cottarelli, 2012b), Mexico, Russia and Spain.

Some advocates of Eurobonds (e.g. De Grauwe, 2013) refer to the early US experience in 1790, when the then-US Secretary of the Treasury, Alexander Hamilton, convinced Congress to pool state debt from the time of the Revolutionary War and assume federal responsibility for its redemption (matched by the assignment of import duties and part of excise taxes on alcohol to the federal budget), which led to building the foundation of fiscal federalism in the US. Yet this comparison is flawed as correctly pointed out by Gros (2010) because there is a large political difference between pooling responsibility for debt accrued during the common war on independence (the case of US) and the debt accumulated as a result of imprudent national fiscal policies and excessive welfare states in peace time (the case of the European debt crisis). In addition, this experience was not painless: it created serious tensions between states and led to over-borrowing and series of states' defaults in 1830s (James, 2012).

#### 4.6. Conclusions

The European debt and financial crisis has led to development of new mechanisms of fiscal surveillance (European Semester) and formal discipline (enhanced SGP, national fiscal rules, Fiscal Compact) as well as new

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<sup>16</sup> Greece is an extreme case, which received its first aid package in May 2010 on the assumption it was illiquid but solvent. Soon this assumption had to be revised, leading to sovereign debt restructuring in 2012.

mechanisms of fiscal solidarity (EFSF and ESM). As result the balance between discipline and solidarity, on the one hand, and between market discipline (based on the ‘no bailout’ provision of the Article 125 of the TFEU and danger of sovereign default) and formal fiscal rules as imposed by the EU legislation has changed in favor of the latter. However, despite their legal strengthening, fiscal rules have not been seriously observed by EU member states and those who breach them do not face sanctions (especially in case of large countries). This results from the lack of sufficient intellectual and political consensus in favor of fiscal discipline as the basic precondition of sustainable economic growth and success of a common currency project as well as inability to build an efficient political coalition to enforce the rules. The same concerns enforcing the ‘no bail out’ clause of the Treaty.

Meanwhile practical suspending of the ‘no bailout’ clause and ECB interventions in favor of troubled countries (see Dabrowski, 2012b; Sinn, 2014) created perverse incentives and moral hazard problem even if they allowed, in short-term, to avoid more sovereign defaults (beyond Greece) and limit the potential contagion to the European banking system and other segments of financial market.

To be precise, one can distinguish between creditor-side and debtor-side moral hazard (see Lane & Phillips, 2000). Low spreads on sovereign bond yields of countries whose long-term fiscal sustainability is evidently problematic thorough most of 2014 (although not as low as before 2008) can be interpreted as presence of the creditor-side moral hazard. Furthermore, increasing spreads for Greece at the end of 2014 and first half of 2015 may be understood as market uncertainty in respect to results of political bargaining between the new government of Greece and official creditors (other Eurozone countries) on new bailout conditions rather than doubts concerning debt sustainability (which was questionable before). Such market behavior means pricing-in expectation of continuous bailouts within the Eurozone and *de facto* debt mutualization (Sinn, 2014).

On the other hand, such phenomena as massive non-observance of EU fiscal rules, symptoms of too-big-to-fail behavior of some member states, limited country ownership of the rescue programs and associated adjustment measures, ex-post bargaining with ‘Troika’ on bailout conditions (the case of Greece) may serve as evidence of borrower-side moral hazard.

Political developments in Greece where the government of Prime Minister Alexis Tsipras formed after the snap election in January 2015 negated the entire rescue program implemented since May 2010 and started bargaining with official creditors (the ‘Troika’) created an additional challenge to the already compromised EU/EMU fiscal discipline mechanism.

Despite substantial debt restructuring in 2012 Greece’s debt-to-GDP ratio in 2013-2014 increased as compared to 2009-2010 (see Table 2) while private creditors were replaced, to a large degree, by the official ones. The latter faced uneasy dilemma: either reject aggressive negotiation tactics of Greek authorities, risking consequences of Greece’s default (including acceptance of huge loses of the ECB, EFSF and ESM and broader-scale contagion effect<sup>17</sup>) or give up and offer Greece a new, even more generous, bailout package. The second option would mean a further slippage towards a dysfunctional fiscal union, facing serious moral hazard problems. Ironically, breaking off negotiation by the government of Greece and defaulting on its IMF liabilities at the end of June 2015 may help rebuilding, at least partly, a market discipline within the EU/EMU, despite associated losses to creditor countries and institutions and contagion risk.

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<sup>17</sup> See Donovan (2015) on potential scenarios of the Eurozone-wide contagion effect of the Gretix, mainly via channel of bank runs. However, these scenarios are based on the assumption that Greece’s sovereign default will lead automatically to its exit from the Eurozone.

## 5. Overall Conclusions and Recommendations

The European debt and financial crisis in the early 2010s triggered a debate on the lacking components of the EU and EMU integration architecture. The frequently expressed opinion is that the very existence of a CCA requires a more advanced stage of fiscal and political integration between their members. Consequently, the sustainability of the common currency depends on how quickly progress in this area can be accomplished.

However, an analysis of both historical and contemporary experiences with monetary unions, especially those initiated by sovereign states, gives a more nuanced picture. In some cases, integration has been limited to the adoption of a common currency/common monetary standard and has not been followed by fiscal and political integration. Despite this limitation, monetary union can work successfully for several decades. In addition, the OCA theory does not provide an unquestionable argument in favor of the necessity to complement monetary integration with the centralization of fiscal resources.

On the other hand, the current integration architecture of the EU/ EMU already contains several elements of fiscal union, such as the EU budget and off-budget bailout facilities, the EU's own revenue sources, limited harmonization of indirect taxes at the national level, substantial cross-country transfers, and fiscal rules and their surveillance. Furthermore, in several important policy areas such as financial supervision, defense, security, border protection, foreign policy, environmental protection, and climate change, the centralization of tasks and resources at the Union level could offer increasing returns to scale and a better chance of addressing pan-European externalities. These are not necessarily related to a common currency and, in most cases, the potential benefits of further integration will cover the entire EU.

Thus, the question of how much fiscal and political integration is needed must be answered on the ground of cost-benefit analysis guided by the theory of fiscal federalism rather than OCA theory. However, in each case, the economic rationale of potential centralization must be confronted with limited appetite of EU member states to delegate new prerogatives to the Union's level, and the principle of subsidiarity, the basic constitutional rule governing the EU.

Union's wide macroeconomic policy coordination and surveillance in other areas than fiscal policy, which expanded institutionally (in the form of MIP and EIP) since 2011, finds even less theoretical justification. If its ultimate goal is to push member states to make their internal markets (especially labor market and capital markets) more flexible, this makes sense from the point of view of the OCA theory (improving factor mobility). Nevertheless, the way in which the MIP has been designed and operates raises several conceptual doubts.

The entire concept of macroeconomic imbalances within the monetary union remains unclear. Concentration on current account imbalances, IIP and real exchange rates ignores the freedom of capital movement and resulting limited or no influence of national policymakers on these variables. The numeric criteria adopted in the MIP Scoreboard look arbitrary. Taking into consideration that MIP and EIP are less strict and involve more conceptual ambiguities, as compared to the SGP and EDP, their enforcement may be even less successful than EU fiscal rules.

Unlike the surveillance of internal macroeconomic imbalances, establishing of sound foundations of fiscal discipline has a key importance for sustainability of a monetary union. As national budgets play and, most likely, will continue playing the most important role in the entire EU budget system, ensuring prudent national fiscal management seems to be the number one challenge, especially in the context of the sovereign over-indebtedness experienced by several member states.

Historical experience demonstrates that market discipline, i.e., the danger of sovereign default, supplemented by clear and consistently enforced fiscal rules, is the best solution to this problem. And this was the founding principle of the EMU at the time of the Maastricht Treaty. Unfortunately, it was changed in 2010 when the 'no bail out' principle was replaced by conditional financial assistance to countries in fiscal troubles, accompanied by building a permanent bailout facility within the EMU. This was the result of giving in to financial market pressure and fear of cross-country contagion when several member states suffered from excessive sovereign debt burden. The parallel effort to strengthen the fiscal rules cannot compensate for a weakening market discipline, especially since national policymakers are not enthusiastic to internalize those rules and observe them in practice. As far as most member states, including the largest ones, experience problems with meeting the TFEU and SGP fiscal targets, the peer pressure mechanism assumed in the SGP and surveillance procedures will not work effectively.

Unfortunately, several proposals floated in the name of building ‘genuine’ economic and monetary union with a strong fiscal component (such as Eurobonds, LOLR or centralized Eurozone funds offering temporary fiscal transfers to member states) could lead to weakening market discipline even further. And they could not be compensated by even more intrusive control of national budgets by the European Commission or other EU governing bodies as suggested in some proposals.

If implemented, such proposals will lead to building a dysfunctional fiscal union, which encourages moral hazard behavior by both national authorities and financial markets. Economic history provides us with numerous examples of dysfunctional fiscal federalism, which resulted in deep fiscal imbalances on the federal level and currency instability. These are the lessons, which must be taken very seriously in the debate on the future of European integration, especially on its fiscal component.

Perhaps the refusal of the Eurozone creditor countries, ECB and IMF to accept demands of the government of Greece for a weaker conditionality and debt forgiveness in the first half of 2015, which resulted in Greece’s default on its official debt will mark a turning point in the hitherto dangerous trend of both weakening a market discipline and leniency in observing enforcement of the EU/EMU fiscal rules. Better late than never...

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## Annex 1: Divergent macroeconomic trends in WAEMU and CEMAC countries

Tables A1 – A5 present basic macroeconomic indicators for the group of eight WAEMU and six CEMAC members in the first decade of the 21<sup>st</sup> century, covering the period of both global financial and economic boom (prior to 2008) and subsequent global financial crisis. Even very superficial look at Tables A1-A5 leads to conclusion that members of both monetary unions represented very divergent macroeconomic trends and high volatility of individual performance, which were determined by various kinds of shocks: changes in commodity prices and volumes of commodity production, natural disasters (for example, droughts), and various kinds of political conflicts, including violent ones. In 1990s and early 2000s most of them faced danger of sovereign insolvency and, as result, benefited from the public debt relief under the Heavily Indebted Poor Countries (HIPC) Initiative (all except Equatorial Guinea and Gabon - see <http://www.imf.org/external/np/exr/facts/hipc.htm>). All those adverse shocks and dramatic circumstances did not undermine stability and sustainability of both common currencies.

Table A1: Annual GDP growth rate, in %, WAEMU and CEMAC

Country	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
<b>WAEMU</b>											
Benin	6.2	4.4	4.0	3.1	2.9	3.8	4.6	5.0	2.7	2.6	3.5
Burkina Faso	6.6	4.4	7.8	4.5	8.7	6.3	4.1	5.8	3.0	8.4	5.0
Côte d'Ivoire	0.0	-1.6	-1.7	1.6	1.9	0.7	1.6	2.3	3.8	2.4	-4.7
Guinea-Bissau	2.0	-1.3	0.4	2.8	4.3	2.1	3.2	3.2	3.0	3.5	5.3
Mali	11.9	4.3	7.6	2.3	6.1	5.3	4.3	5.0	4.5	5.8	2.7
Niger	8.0	5.3	7.1	-0.8	8.4	5.8	0.6	9.6	-1.0	10.7	2.2
Senegal	4.6	0.7	6.7	5.9	5.6	2.4	5.0	3.7	2.2	4.3	2.6
Togo	-1.6	-0.9	5.0	2.1	1.2	4.1	2.3	2.4	3.5	4.0	4.8
<b>CEMAC</b>											
Cameroon	4.5	4.0	4.0	3.7	2.3	3.2	2.8	3.6	1.9	3.3	4.1
Central African Republic	0.4	0.3	-6.8	2.6	2.5	4.8	4.6	2.1	1.7	3.0	3.3
Chad	11.7	8.5	14.7	33.6	7.9	0.6	3.3	3.1	4.2	13.6	0.1
Republic of Congo	3.8	4.6	0.8	3.5	7.8	6.2	-1.6	5.6	7.5	8.8	3.4
Equatorial Guinea	63.4	19.5	14.0	38.0	9.7	1.3	18.7	13.8	-3.6	-2.6	4.6
Gabon	2.2	-0.7	1.7	1.1	1.5	-1.9	5.2	1.0	-2.9	6.7	7.1

Note: yellow field indicates IMF estimate

Source: IMF World Economic Outlook database, October 2013

Table A2: Annual inflation, end-of-year, in %, WAEMU and CEMAC,

Country	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
<b>WAEMU</b>											
Benin	2.3	1.2	0.8	2.7	3.7	5.3	0.3	8.4	-0.5	4.0	1.8
Burkina Faso	0.9	3.9	3.2	0.7	4.5	1.5	2.3	11.6	-0.3	-0.3	5.1
Côte d'Ivoire	4.8	4.4	-0.1	4.4	2.5	2.0	1.5	9.0	-1.7	5.1	2.0
Guinea-Bissau	-1.9	2.5	0.7	2.9	-1.0	3.2	9.3	8.7	-6.4	5.7	3.4
Mali	5.2	4.1	-5.0	1.5	3.4	3.6	2.6	7.4	1.7	1.9	5.3
Niger	3.2	0.6	-1.5	3.7	4.2	0.4	4.7	9.4	-0.6	2.7	1.4
Senegal	4.1	1.5	-1.5	1.7	1.4	3.9	6.2	4.3	-3.4	4.3	2.7
Togo	6.9	1.6	-1.7	3.9	5.5	1.5	3.4	10.3	0.6	3.7	1.5
<b>CEMAC</b>											
Cameroon	5.0	2.4	-0.1	1.0	3.5	2.4	3.4	5.3	0.9	2.6	2.7
Central African Republic	2.5	9.1	-1.3	-0.3	2.2	7.1	-0.2	14.5	-1.2	2.3	4.3
Chad	0.7	12.6	-11.9	9.2	-3.4	-0.9	1.7	9.7	4.7	-2.2	10.8
Republic of Congo	8.3	-2.9	6.7	1.1	3.1	8.1	-1.7	11.4	2.5	5.4	1.8
Equatorial Guinea	12.2	6.2	5.9	5.1	3.2	3.8	3.7	5.5	5.0	5.4	4.9
Gabon	0.9	0.4	3.5	-0.5	1.1	-0.7	5.9	5.6	0.9	0.7	2.3

Note: yellow field indicates IMF estimate

Source: IMF World Economic Outlook database, October 2013

Table A3: General government net lending/borrowing, in % of GDP, WAEMU and CEMAC

Country	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
<b>WAEMU</b>											
Benin	-4.8	-5.0	-1.6	-1.1	-2.3	-0.2	0.3	-0.1	-3.3	-0.4	-1.4
Burkina Faso	-4.0	-5.0	-2.0	-4.7	-5.5	16.1	-6.7	-4.3	-5.3	-4.6	-2.4
Côte d'Ivoire	0.9	-1.1	-2.1	-1.7	-1.7	-1.8	-0.8	-0.6	-1.6	-2.3	-5.7
Guinea-Bissau	-5.1	-6.4	-7.3	-8.7	-7.6	-5.5	-10.6	-2.4	1.6	-2.1	-2.1
Mali	-3.2	-3.8	-1.3	-2.6	-3.1	31.3	-3.2	-2.2	-4.2	-2.7	-3.7
Niger	-3.5	-3.0	-2.8	-3.5	-2.0	40.3	-1.0	1.5	-5.4	-2.4	-1.5
Senegal	-2.4	-0.7	-1.8	-2.3	-2.8	-5.4	-3.8	-4.7	-4.9	-5.2	-6.3
Togo	-1.1	-0.4	2.4	1.0	-2.4	-2.8	-1.9	-0.9	-2.8	-1.6	-2.9
<b>CEMAC</b>											
Cameroon	0.7	1.7	0.7	-0.5	3.6	32.8	4.7	2.2	-0.1	-1.1	-2.7
Central African Republic	-0.9	-1.2	-3.3	-2.1	-4.6	9.1	1.2	-1.0	-0.1	-1.4	-2.4
Chad	-4.6	-5.3	-5.6	-2.4	-0.1	2.2	2.5	3.6	-9.2	-4.2	2.4
Republic of Congo	6.4	-0.3	0.4	3.6	14.6	16.6	9.4	23.4	4.8	16.1	16.4
Equatorial Guinea	17.8	20.9	15.6	12.9	22.8	28.3	21.8	18.7	-9.4	-6.1	1.0
Gabon	3.9	3.6	7.5	6.8	7.8	8.3	8.0	10.9	6.8	2.7	2.4

Note: yellow field indicates IMF estimate

Source: IMF World Economic Outlook database, October 2013

Table A4: General government gross debt, in % of GDP, WAEMU and CEMAC

Country	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
<b>WAEMU</b>											
Benin	55.7	45.8	35.1	32.8	40.6	12.5	21.2	26.9	27.3	30.2	31.9
Burkina Faso	n/a	48.7	44.6	45.8	44.1	22.6	25.4	25.2	28.6	29.3	29.7
Côte d'Ivoire	104.4	93.6	90.4	84.9	86.3	84.2	75.6	75.3	66.5	66.4	94.9
Guinea-Bissau	240.6	263.5	252.5	235.4	216.2	213.8	186.9	157.7	164.3	51.7	45.8
Mali	91.6	54.2	49.2	46.4	53.1	20.4	21.1	22.6	24.7	28.7	29.2
Niger	109.3	114.1	89.7	75.6	66.3	27.1	25.4	21.3	28.1	24.0	27.7
Senegal	70.9	68.0	54.7	47.5	45.7	21.8	23.5	23.9	34.2	35.7	40.0
Togo	109.4	107.0	108.6	99.6	82.2	91.3	107.8	89.0	73.4	47.3	45.3
<b>CEMAC</b>											
Cameroon	70.8	64.3	60.3	61.6	51.5	15.9	12.0	9.5	10.6	12.1	13.8
Central African Republic	103.3	100.5	102.7	103.9	108.8	94.7	79.1	80.2	36.8	32.3	32.6
Chad	56.3	50.3	41.0	30.2	26.6	26.5	21.1	18.9	23.3	26.3	31.3
Republic of Congo	195.8	180.3	204.4	198.7	108.3	98.8	98.0	68.1	61.6	22.9	30.3
Equatorial Guinea	29.9	25.7	12.9	7.6	3.7	2.0	1.3	0.8	6.0	6.0	9.0
Gabon	78.1	78.3	67.9	58.5	48.1	38.1	39.5	16.7	23.3	20.3	17.3

Note: yellow field indicates IMF estimate

Source: IMF World Economic Outlook database, October 2013

Table A5: Current account balance, in % of GDP, WAEMU and CEMAC

Country	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
<b>WAEMU</b>										
Benin	-4.0	-7.3	-8.4	-6.7	-6.5	-4.9	-10.2	-8.1	-8.9	-8.7
Burkina Faso	-11.9	-10.9	-9.6	-11.0	-11.6	-9.5	-8.3	-11.5	-4.7	-2.2
Côte d'Ivoire	-0.6	6.7	2.1	1.6	0.2	2.8	-0.2	2.3	7.6	2.5
Guinea-Bissau	-0.1	-0.8	-0.5	1.4	-2.1	-5.6	-3.5	-4.9	-6.7	-8.6
Mali	-10.2	-2.5	-6.6	-7.5	-8.1	-3.7	-6.3	-12.2	-7.3	-12.6
Niger	-5.1	-9.7	-7.5	-7.3	-8.9	-8.6	-8.3	-13.0	-24.7	-19.9
Senegal	-5.0	-6.0	-6.4	-6.9	-8.9	-9.2	-11.6	-14.1	-6.7	-4.4
Togo	-8.5	-8.0	-10.8	-10.0	-9.9	-8.4	-8.7	-6.9	-6.6	-6.7
<b>CEMAC</b>										
Cameroon	-5.8	-5.1	-1.8	-3.4	-3.4	1.6	1.4	-1.2	-3.3	-3.0
Central African Republic	-1.9	-1.7	-2.3	-1.8	-6.6	-3.0	-6.2	-10.0	-9.2	-10.2
Chad	-28.1	-83.7	-43.3	-15.1	1.0	5.1	9.4	7.2	-3.1	-4.0
Republic of Congo	-4.6	0.6	4.8	-5.7	3.7	3.6	-6.5	-0.6	-6.0	3.8
Equatorial Guinea	-50.9	1.1	-41.2	-26.7	-7.7	-1.1	-3.0	-1.2	-17.8	-24.0
Gabon	9.9	6.1	8.5	10.0	20.4	14.1	14.9	23.4	7.5	8.9

Note: yellow field indicates IMF estimate

Source: IMF World Economic Outlook database, October 2013