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THE EUROZONE CRISIS PROCESS ANY PATTERNS OF EUROPEAN INTEGRATION?

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Abstract

The paper looks at the EMU's purposes and achievements, at the criticism of its architecture, at the successive moments of the eurozone crisis and at the successive reactions within the EU meant to counter the crisis, in order to trace features and patterns of behaviour. Neofunctionalists are discussing about integration as spillover from one policy area to another and from the economic sphere to the political one. The paper will explore the extent to which such spillover phenomena actually took place during the eurozone crisis and the extent to which we can talk about deepening the integration of the EU as a result of the measures taken to counter the eurozone crisis.

Keywords: eurozone crisis, European Monetary Union, spillover, European Central Bank, European integration

1. European Monetary Union. History, purposes, achievements

The idea of an economic and monetary union (EMU) in the European Communities came as a natural continuation of the objective of building a common market, as written in the Treaty of Rome in 1957. The origins of the EMU is also linked to the collapse of the international monetary anchor provided by the dollar-gold standard in 1971 and a new wave of currency instability as a result of the energy shocks in the 1970s [*The Future of the Eurozone and U.S. Interests*, Congressional Research Service Report of 17 January 2012, p. 4, online at www.crs.gov]. As a result of these combined concerns, EEC set up a European Monetary System in 1979, introducing fixed exchange rates for EEC currencies, which could be adjusted within certain limits.

The creation of the EMU was based on a plan, devised at the initiative of Jacques Delors, the president of the Commission between 1985 and 1995 – a European politician with a vision of a united Europe, which inspired major achievements within EEC/EU for more than a decade. EMU is part of the Maastricht Treaty. The institution set up to be responsible with the **monetary policy** related to the common currency, the Euro, was the European Central Bank (ECB). The ECB together with the central banks of all the members of the

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European Union form the European System of Central Banks (ESCB) which is charged by statute with **maintaining price stability** as its primary objective. Established by the Treaty of Amsterdam in 1997, ECB started to function on the 1st of June 1998. ECB was meant to secure a common monetary **policy independent of any political influence**. Fiscal policy, that is, decisions about spending and taxation were left to the eleven member states, under the conditions of the 1997 Stability and Growth Pact. The last stage in the EMU plan (stage three) involved a few important elements: **fixing irrevocably the exchange rate of each currency** participating in the union, conduct of a single monetary policy by the ESCB and entry into force of the Stability and Growth Pact (SGP) [‘Economic and Monetary Union (EMU)’, online at http://www.ecb.int/ecb/history/emu/html/index.en.html]. The SGP is intended to ensure that Member States maintain budget discipline in order to avoid excessive deficits. SGP was modified several times since its entry into force, in order to improve discipline among member states. SGP is supposed to contribute to monetary stability in the eurozone. EMU’s official beginning is January 1, 1999, when eleven EU members pegged their currencies at a fixed exchange rate in preparation for adoption of the Euro - the common currency.

A number of changes to the SGP were made in 2005, in order to make **more flexible** the participation of MSs to the eurozone. The modified SGP provides that each MS may develop its own medium-term objectives to bring its deficit spending and its debt level into compliance based on each MS’s particular economic conditions. This was an attempt to reform the Euro system and make it friendlier for the MSs.

Given that the main objective of the Eurosystem (ESCB and the ECB form together the Eurosystem) is the maintaining of the price stability, that is, the **safeguarding the value of the euro** [‘The mission of the European Central Bank’, online at http://www.ecb.int/ecb/html/mission.en.html], the Eurosystem’s focus is to defend the value of Euro in relation to other currencies. However, the Eurosystem has legally a limited range of intervention inside the EU, because most prerogatives belong to Member States (MS).

Under some interpretations, ”[t]he primary rationale for the EMU was to provide momentum for political union, a long-standing goal of many European policymakers” [*The Future of the Eurozone and U.S. Interests*, Congressional Research Service Report of 17 January 2012, p. 4, online at www.crs.gov]. Each MS had its own rationale to proceed in the direction of the EMU, not necessarily reasons that overlapped. The EMU was called „**the mother of spillovers**” [1] – given the proportion of changes and depth of changes in terms of common policies and integration supposed by its proper functioning. Thus, the main achievement of the EMU is **the promise of a much deeper degree of integration** of the EU. In fact, the EMU seems to be, looking back in retrospective, a rather risky enterprise, in the shape it was thought and implemented up to this point. The common currency became part of most of EU’s **economic life**. The eurozone enlarged from 11 members in its inception to

17 members today – with the last country to join, Estonia, in full eurozone crisis. The Euro became part of the EU's **identity**.

2. The eurozone architecture criticized

From the very beginning of the functioning of EMU, a series of specialists and politicians indicated reservations with respect to its viability. Relatively soon after being implemented, EMU's architecture began to show its weaknesses. One round of reform in 2003 – 2005 seemed to be shallow and unsatisfactory. A series of contradictions became obvious in the background of the financial and economic crisis started in 2008. They are built around two poles: the **common monetary policy** of the ECB/ESCB on the one hand and the **non-common fiscal policies** of the MSs' governments. „Weak enforcement of fiscal discipline, over time, facilitated rising public debts in some of the countries. **Locked into the euro**, individual members cannot inflate their way out of large public debt or devalue their currency to make their exports more competitive" [*The Future of the Eurozone and U.S. Interests*, Congressional Research Service Report of 17 January 2012, p. 2, online at www.crs.gov]. The creation of the Euro meant that members of the eurozone lost their ability to use monetary and exchange rate policy tools as a way to respond to changes in economic conditions [2].

Many critics of EMU architecture emphasize that its biggest weakness resides in the fact that it erected a currency with a central bank but without a government that has taxation and a spending authority. As Soros put it: there is a „hidden weakness in the construction of the euro: the lack of a common treasury" [3]. The negative consequences of this architecture gradually built in two directions: (1) increasing incapacity of ECB to act effectively in relation to its main function, the stability of the Euro, and (2) increasing incapacity of the MSs' governments to act flexibly, according to the performances of their respective economies, given the fact that they are locked-in the eurozone currency system. If ECB sets a common interest rate, say X, X may end up being too high for the high unemployment country – Spain, for example.

Another strand of criticism indicated the fact that the adjustment mechanisms for MSs were not developed enough. The costs of being locked in the Euro system need to be compensated. „These adjustment mechanisms, in the absence of a common federal budget and robust transfer mechanisms from countries experiencing booms to the countries experiencing recessions, include **labor and capital mobility** and **wage and price flexibility**. For example, the unemployment disparities could be reduced if workers from a country with high unemployment relocated to the one with low unemployment. Or, relative labor costs could fall in the high unemployment country to attract investment and create new jobs. In the absence of viable adjustment mechanisms, there are likely to be strains and tensions within a currency union." [D. Faltin and K. Klingensmith, Eurozone Economics: The Future of the Euro in Jeopardy, *UBS Wealth Management Research*, July 13, 2010]

Some economists predicted that the monetary union would not survive because of shortcomings in its architecture divided into **the North** (the Northern European countries, more developed and strong economically) and **the South** of the EU (Greece, Ireland, Italy, Portugal, Spain (GIIPS). The obstacle of a common currency was supplemented by the lack of adjustment mechanisms that can bridge the gap in competitiveness between the North and the South within the EU. The economic cultures of at least some of these countries add to the discrepancies that may render a common Euro difficult. That is to say, at least some countries in the North have an economic culture oriented towards the avoidance of inflation and tight budgets (like Germany), whereas some countries in the South have a more spendthrift pattern of economic culture and behaviour.

3. The eurozone crisis. (Re)Actions to counter the crisis

3.1. The crisis unfolded. Measures taken

The eurozone crisis started as a debt crisis in the weaker chains of the Eurosystem, in the Northern countries: Greece, Ireland, Portugal, Spain, Italy – but first and foremost Greece, in early 2010. In December 2009, Greece admits that its debts have reached 300bn euro - the highest in its modern history. Soon after, an EU report condemns ‘severe irregularities’ in Greek accounting procedures (January 2010). Greece’s revised budget deficit turns out to be four times the maximum allowed by SGP (12.7%, compared to 3.7%). Fears of Greek default and speculations that Greece might leave the Euro, in the beginning of 2010, had a strong impact on the confidence in Euro and on the solidity of the eurozone.

After two offers of insufficient emergency loans from eurozone countries for Greece, on the 2nd of May 2010, the eurozone members and the IMF agree a 110bn-euro bailout package to rescue Greece. Later on, in November, the EU and IMF agree to a bailout package to the Irish Republic of 85bn euros. The Irish Republic soon passed the toughest budget in the country's history. The decision and implementation of austerity measures in Greece was more difficult, took longer and was accompanied by massive street protests. The proportions of reforms necessary to be done in Greece was on a par with the protests.

In May 2010, the EU and the eurozone MSs set up the European Stabilization Mechanism consisting of (a) the European Financial Stabilization Mechanism (EFSM), and (b) The European Financial Stability Facility (EFSF) – to safeguard EU financial stability in euro-area sovereign debt markets. Also, funding from IMF and „possible ECB purchases of sovereign debt” are included in the safety-net European Stabilization Actions [‘European Stabilisation Actions - the EU´s response to the crisis’, online at http://ec.europa.eu/economy_finance/eu_borrower/european_stabilisation_actions/index_en.htm].

The European Financial Stability Facility (ESFS) was **created by the eurozone MSs** within Ecofin Council, on 9 May 2010 [Council of the European Union, Press Release, Extraordinary Council Meeting, Economic and Financial Affairs, Brussels, May 9/10, 2010, online at http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/114324.pdf]. ESFS is authorized to provide loans to countries in difficulty and finance recapitalizations of financial institutions through loans to governments, as well as intervening in primary and secondary markets (only on the basis of ECB approval). ESFS is backed by guarantee commitments from eurozone MSs for a total of 780 billion Euros and has a lending capacity of 440 billion Euros [‘About EFSF’, online at www.efsf.europa.eu]. EFSF was created **outside the EU** system, being established under Luxembourg law as a limited liability corporation, for a period of three years. The EFSF was expected to be replaced by a permanent lending facility, the European Stability Mechanism (ESM), after it expires in 2013. At the December 2011 Summit, leaders announced that this timeline would be accelerated to July 2012 so that it could overlap with the EFSF for a year.

The EFSM is a €60 billion supranational EU balance of payments loan facility available to any EU member country facing financial difficulties. EFSM is a facility created within EU, not only within the eurozone. Under the EFSM, the **European Commission** is allowed to raise up to €60 billion on the international capital market by **issuing bonds** individually and collectively backed by all 27 EU member states. EFSM loans require a qualified majority vote of the Council of the EU. The borrowing MS would be subject to economic conditionality supervised by the European Commission. Beginning in January 2011, several bond offerings have been placed to partially fund the Ireland and Portugal assistance packages.

The process of creating facilities to offer loan and financial means to cope with the sovereign debt issue in the weakest Southern countries – the rescue packages for Greece, Ireland, Portugal – were accompanied by a process of devaluation of the euro in the international market of currencies. The trust in the euro worldwide was shattered and the costs of borrowing for the affected countries rose significantly.

If the acute manifestation of the sovereign debt crisis in Greece was followed by the creation of the European Stabilization Mechanism, the rescue package for Ireland was followed by **new institutional developments**. Thus, Regulation (EC) No. 1093/2010 of the European Parliament and of the Council of 24 November 2010 established the European Banking Authority (EBA). The EBA has officially come into being as of 1 January 2011. It has taken over all existing and ongoing tasks and responsibilities from the Committee of European Banking Supervisors (CEBS). The EBA acts as a network of EU and national bodies safeguarding the stability of the financial system, the transparency of markets and financial products and the protection of depositors and investors. The EBA has some quite broad competences, including strengthening international supervisory coordination, promoting supervisory convergence and providing advice to the EU institutions in the areas of banking, payments and e-money regulation.

A Joint Committee was set up to **coordinate important European institutions** in the financial area, in the beginning of 2011. Its goal is to strengthen „cooperation between the European Banking Authority (EBA), European Securities and Markets Authority (ESMA) and European Insurance and Occupational Pensions Authority (EIOPA), collectively known as the three European Supervisory Authorities (ESAs). [...] In particular, the Joint Committee works in the areas of supervision of financial conglomerates, accounting and auditing, micro-prudential analyses of cross-sectoral developments, risks and vulnerabilities for financial stability, retail investment products and measures combating money laundering." ['Joint Committee', online at http://www.eba.europa.eu/Joint-Committee.aspx] The Joint Committee also plays an important role in the information exchange between the European Systemic Risk Board (ESRB) and the ESAs.

The rescue packages for Greece and Ireland were followed by a rescue package for Portugal in May 2011, when the eurozone and the IMF approved a 78 billion euro bailout for Portugal. The institutional strengthening wave at the end of 2010 – January 2011 was followed by the set up by eurozone finance ministers of a **permanent bailout fund**, called the European Stability Mechanism (to be differentiated from the European Stabilisation Mechanism set up in May 2010). On 11 July, finance ministers of the Eurozone signed the **Treaty establishing the European Stability Mechanism** (ESM) with a lending capacity ceiling of 500 billion euros ['European Stability Mechanism treaty signed', online at http://consilium.europa.eu/homepage/showfocus?lang= en&focusID= 79757]. Any euro-area Member State receiving assistance must implement a macro-economic adjustment programme and a rigorous analysis of public-debt sustainability, and foresee IMF participation in liaison with the ECB. The Commission anticipated the need for more funds and particularly for more solid grounds for the euro investors, in order to boost the trust in the economies of the euro area. Actually, a second bailout for Greece was agreed subsequently. The eurozone agreed a comprehensive 109 billion euro package designed to resolve the Greek crisis and prevent contagion among other European economies. The package heavily conditioned Greece with structural reforms and austerity measures – given the fact that the bailout was offered under the new treaty signed.

Amidst growing concerns that the sovereign debt crisis may spread to larger economies, like Spain and Italy, **European Central Bank started to buy Italian and Spanish government bonds** in August 2011, in order to try to reduce their borrowing costs. In anticipation of the new European Pact to be adopted in March 2012, Spain followed the line promoted by Germany and passed a constitutional amendment (September 2011) to add in a 'golden rule', keeping future budget deficits to a strict limit. Spain was the first state to do this. It was followed by other countries that signed the 2012 Treaty. The threat of crisis contagion to Spain and Italy – big economies (particularly Italy) – became prominent. Italy's sovereign debt reached 1.9 trillion euro [G.D.Halbert, 'The European Debt Crisis is Spreading', *Blog www.investorsinsight.com*, online at http://www.investorsinsight.com/blogs/forecasts_trends/archive/2011/08/09/the-european-debt-crisis-is-spreading.aspx].

Despite the measures taken up to this point, the stability of Euro continued to be threatened. At the end of September 2011, the President of the Commission, Jose Manuel Barroso, warned that the EU 'faces its greatest challenge'. In a bleak note, Foreign Secretary William Hague called the euro a 'burning building with no exits'. Such statements may have added to the diminished trust in a solution to the crisis in the eurozone. Under these circumstances, the European Central Bank unveils emergency loans measures to help banks (October); the very same day, the Bank of England injected a further £75 billion into the UK economy.

On 26 October European leaders reached a **'three-pronged' agreement** described as vital to solve the region's huge debt crisis. After marathon talks in Brussels, they agreed to boost the eurozone's main bailout fund to about 1 trillion euro. Banks have agreed to shoulder losses on Greek bonds, the country's burden has been reduced, cutting its debt down to 120% of its GDP by 2020. Bank recapitalization was the third key element of the package. However, this, third element involves a more hand-on approach to the relationship between the center and European banks. The deal contributed to the lift the euro at least in the short run.

At the EU summit on December 8-9, 2011, EU leaders announced a number of new policy measures, including a fiscal compact and extension of bilateral lines of credit from European countries to the IMF, to address the eurozone crisis [Statement by the Euro Area Heads of State or Government, December 9, 2011, online at http://www.consilium.europa.eu.uedocs/cms_Dat/ docs/pressdata/en/ec/126658.pdf]. The main purpose of the fiscal compact is an agreement that government budgets should be balanced or in surplus, and that constitutions of MSs should be amended to reflect this rule. The European Court of Justice is involved in the sanctioning of governments that do not abide by the treaty and a fine is attached for the lack of compliance. The *Treaty on Stability, Coordination and Governance in the Economic and Monetary Union* is an intergovernmental pact signed by all EU members, except Czech Republic and the UK, on the 2nd of March 2012. It will enter into force in January 2013.

The banking part of the European leaders deal implied certain rules considered inadequate by critics. „The EBA has drawn sharp criticism from bankers and politicians for demanding that banks boost the size of their holdings of top quality capital to 9 per cent of their assets, adjusted for risk, by June 2012. They argue that weak banks are being forced to cut lending and pull out of markets at a time when the 27-nation bloc needs credit to grow." [4] The new rules represent an attempt by the EBA to tighten the coordination of the eurozone banks, to have more reliable information about what is going on in each member state's banking sector, to make sure there are no hidden difficulties, no unknown risks, and to support coordination policy responses. The head of EBA, Andrea Enria made a strong case for constrained discretion and harmonized rules. “We are running the risk to open a wide area for discretion in national supervisory implementation, with national policy makers – not only in Europe – potentially able to hide everything under the macroprudential umbrella,” he warned. “Systemic risk cannot be contained any more within national borders and requires coordinated policy responses” [4].

During the whole eurozone crisis, ECB had a crucial role. Starting in May 2010, ECB board decided to set up the securities markets programme as well as to prepare for giving out long term loans to MSs. ECB also intervened in the European banking system. The intervention between in these areas changed, depending on the necessities of the moment. „It is believed that the ECB is now among the largest holders of Greek, Italian, and Portuguese debt. Given a sharp increase in buying beginning in August 2011, the ECB as of mid-year 2011 held €143 billion of European sovereign debt” [*The Future of the Eurozone and U.S. Interests*, Congressional Research Service Report of 17 January 2012, p. 16, online at www.crs.gov]. In December 2011 the ECB provided an unusual flexible liquidity support to euro area banks. The ECB awarded 523 banks with €489 billion euros (about $639 billion) in loans at the average benchmark interest rate of 1% over a three year period. This was called the biggest infusion of credit ever into the banking system [*The Future of the Eurozone and U.S. Interests*, Congressional Research Service Report of 17 January 2012, p. 16, online at www.crs.gov]. If ECB got involved in the security markets during August and following months in 2011, particularly due to Spain and Italy difficulties, ECB has preferred to concentrate on a €1 trillion injection of three-year loans into the eurozone banking system.

3.2. Criticism, solutions, scenarios

One of the main criticisms of the crisis response measures is that they were **not addressing structural matters** of the EU monetary architecture. It was suggested that these measures were rather buying time for EU leaders to adopt fundamental changes in governance. Ken Rogoff, a former chief economist at the International Monetary Fund, said that the euro was a ‘halfway house that doesn't work’. Another major strand of criticism is that despite the fiscal measures, the austerity conditions imposed will hamper economic growth. The credits crunch in Europe means very little or no growth. „Eurozone economies will find it very difficult to restore public finances and regain competitiveness in the absence of more rapid economic growth” [5]. That is to say, austerity measures are not enough to get EU economy healthier. The link between public finances and growth must be restored. Or, as Roubini puts is „The trouble is that the Eurozone has an austerity strategy but **no growth strategy**”. The lack of growth reinforces the crisis. The lack of structural reforms renders shallow the solutions given.

Criticism tends to group around two directions: 1. ECB should take more responsibilities and 2. the strict austerity measures taken are not adequate because they hamper economic growth.

In a recent Congressional Research Service report, The Future of the eurozone and U.S. Interests' of 17 January 2012, the authors see three possible scenarios for the future of Euro.

1. Eurozone breaks apart – as a result of the exit by one or more Southern Countries or as a result of the exit by one or more Northern Countries.
2. Eurozone survives; Southern states go through austerity and structural reforms; however not a fiscal union; this scenario will work if the financial markets have confidence in the measures taken by the EU, believe the authors.
3. the **Eurozone becomes more integrated**; this presupposes:
   - implementing reforms to reduce fiscal free-riding (fiscal coordination already initiated through the Fiscal Pact signed in March)
   - greater fiscal federalism
   - a secure mechanism to give financial assistance to countries in need (already founded)
   - ECB assumes new powers (already exercised powers beyond its legal status).

Joseph E. Stiglitz views three solutions for the crisis [J. Stieglitz, 'Can the Euro be Saved?', Project Syndicate, 5 May 2010] – writing about it right in the beginning of the euro turmoil:

(a) engineering by the eurozone countries the equivalent of a devaluation – a uniform decrease in wages; the consequences of such a move would be unacceptable, because the social tensions would be enormous; this is not a feasible alternative in Stiglitz's opinion;

(b) the exit of Germany from the Eurozone or the division of the Eurozone into two sub-regions – euro may fail like the almost-forgotten ERM that preceded it and fell apart when speculators attacked the British pound in 1992; the Euro 'lacks the institutional support required to make it work';

(c) implementing **institutional reforms**, including the necessary fiscal framework, that should have been made when the euro was launched – which Stiglitz believes is the most promising of all.

Both scenarios point to the fact that institutional reform and stronger integration moves would the best solution to the present crisis. The idea of a 'leap in integration', including the political dimension to the integration, giving up more sovereignty and handing over control of attributes at the core of MSs sovereignty, seem to be the most secure solution. If we look at other assessments of the measures taken already, we may notice similar trends. George Soros is one of the critics pointing in the same direction, when he writes about EU's lack of a common treasury. The question that arises here is: What is the **feasibility of radical measures**, given the history but also the present willingness of the actors involved in the European construction. As Jacob Funk Kirkegaard put it: „A European fiscal union with regular, institutionalized and large transfers between

Eurozone members (analogous to a federal European budget) is not politically feasible in Europe. […] A middle-ground perspective holds that Europe has the option to muddle through the crisis by introducing a combination of liquidity facilities and reforms that will lower fiscal deficits and raise economic growth in financially troubled member states.” [6]

The measures taken so far by the European institutions and governmental representatives indicate that they are trying to find solutions to avoid a fundamental structural reform. The politics of small steps, even though in the last two years they were rather medium ones, are meant to avoid the big leap. Phillip Whyte believes that the system of rules established in the past two years are meant to establish a pan-European ‘stability culture’. “Once that culture has been established, greater fiscal integration will be possible. In the meantime, embryonic federal institutions are slowly emerging. The eurozone’s bail-out fund could be viewed as a nascent debt agency. And the European Supervisory Authorities that were set up in 2011 could develop into a unified banking supervisory system with common fiscal resources to rescue and recapitalize banks.” [P. Whyte, ‘Governance reforms have left the euro's flawed structure intact’, online at http://centreforeuropeanreform.blogspot.co.uk/2012/04/governance-reforms-have-left-euros.html]

4. Neofunctionalist claims

Neofunctionalism is a theory of European integration which was very much present in the explanations of European integration in the 1950s and 1960s – particularly before the Luxembourg compromise in 1966. Its forefather was a Jewish Romanian theorist, David Mitrany, emigrated to the USA – the founder of functionalism. Ernst Haas was the main proponent of this view of European integration and he was an enthusiast in the 1950s and the 1960s, but also denounced neofunctionalist framework as falling into obsolescence in the 1970s. The revival of neofunctionalist approaches is related to the new confidence and trust in European integration generated by the Single European Act, signed in 1986. New setbacks were recorded on the occasion of the failure of the projected European Constitution and even of the Constitutional Treaty in mid 2000s.

The crisis of the euro area raises new question related to the capacity of the neofunctionalist theory to explain the way in which Europeans solve the problems generated by it. Prominent theorists, writing about Haas, assert that „by now almost everyone recognizes that no single theory or approach can explain everything one would like to know or predict about the EU” [1, p. 280]. Nonetheless, neofunctionalism offers a series of insightful concepts and predictions meant to understand the process of European integration. Among these, the concept of spillover from one policy area to another has a privileged place. Integration in one economic sector will generate strong incentives for integration in further economic areas. Neofunctionalism has a stronger claim: that economic integration will create the conditions for deepening integration in the political realm.

Neofunctionalism includes among its main explanatory factors the socialization of elites into European values and culture. For Haas, the essence of European integration resides in the change of loyalties – from national to European. Elites are changing their loyalty – they move from their allegiance to their states towards the central European allegiance. To the extent that individuals, elite individuals, are driving forces of integration, their loyalty is of the essence of furthering and deepening European integration. But this is one facet of the neofunctionalist approach. Another one is related to the shift of authority from national governments towards supranational governance. Wayne Sandholtz and Alec Stone Sweet, two prominent followers of Ernst Haas, write "[n]eo-functionalism accounts for the migration of rule-making authority from national governments to the European Union. We refer to the EU's capacities to create, interpret, and enforce rules as 'supranational governance'." [W. Sandholz and A. Stone Sweet: Neo-functionalism and Supranational Governance, 2010, electronic copy available at: http://ssrn.com/abstract=1585123]

This paper proposes to look at the events, measures and processes that have happened over the past two and a half years with the EMU through this neofunctionalist lens and try to identify the areas in which a spillover process happened or is under way of happening. It is also trying to look at the way they happened, how the governmental actions and values overlapped or were overcame by European actions and values. Foremost, the focus of this paper is to look at the transfer of sovereignty from the national to the supranational European institutions.

The solutions and scenarios described in the previous section indicate a radical spillover in the EMU, but the history of the EU shows that apart from the founding Rome Treaty and perhaps the Single European Act, all other changes in the EU were rather evolutions rather than revolutions.

5. The euro crisis: what are the features of the integration process?

Maintaining the euro as the common EU currency is an important stake for the whole European construction effort. The German Chancellor Angela Merkel said that the currency union is a matter of the preservation of the European idea. "If the euro fails, Europe fails" she said ['Merkel Says EU Must Be Bound Closer Together', Spiegel Online, http://www.spiegel.de/international/germany/0,1518,784953,00.html, 9 July 2011]. According to World Bank figures, the GBP of the eurozone was $12.2 trillion in 2010, 16 – about 19% of world GDP (the GDP of the USA in 2010 was about $14.6 trillion). The eurozone counted for 29% of total world exports and 28% of world imports; also, as 23% of world net inflows of foreign direct investment (FDI) in 2010 [*The Future of the Eurozone and U.S. Interests*, Congressional Research Service Report of 17 January 2012, p. 4, online at www.crs.gov]. The breakdown of the Euro area was equaled with the dissolution of the EU. The "bicycle principle" of keeping on pedaling, of keeping on riding would be broken, the bicycle derailed, and the EU project dead. „To the surprise of almost everyone, the introduction of the new common currency produced relatively little resistance, and this 'mother of all spillovers', as it became known, has been a quiet yet historic success" [1, p. 279] – write several prominent political scientists of our time. But under the surface, EMU hid less supranational commitment than appeared under the name 'Union'. A great deal of policies behind a common currency was left decentralized, being kept as part of the MSs policy domain. Some of the consequences of the implementation of those EMU-related policies were swept "under the carpet" over the last decade. Being nicely decorated over the years, they remained hidden, but were uncovered on the occasion of the current eurozone and economic crisis in EU.

The maintaining of the Euro and finding solutions for the maintenance of the Eurozone represent huge stakes for the MSs as well as for keeping the EU's position in the world economy. It is important to mention in this context that the crisis was triggered not only by internal dysfunctions of the EMU but also by global forces. In this sense, Haas was writing „The events in the world economy in the last few years suggest that regional policy making is more and more constrained by the extra and inter-regional economic calculations of the actors" [7]. The EU needs to do whatever it takes to save the eurozone, given the high stake it represents, taking into consideration the global context. During the crisis, a series of institutions and powerful global states intervened in various ways in order to support the stability of Euro – IMF, USA, China, G7, G20 etc.

The European Monetary Union project was seen as 'the mother of spillovers' precisely because of the complexity of the processes involved in and emerged from it. The present unfolding eurozone crisis, combined with a growth crisis in the EU, is the expression of this complexity. A series of tensions and contradictions that accumulated in the EU over the past two – three years can be identified, as follows.

One of the main tensions developed is the one between the austerity measures and financial discipline (required by the central institutions of the EU – Commission, ECB – as well as by the Fiscal Compact of March 2012) on the one hand, and the need of the EU economy to grow in order to sustain the payments incurred by debts (if not for its own sake). The Prime Minister of the Netherlands stepped down because of the tough measures necessary to be adopted by the government. And his was not the only European government to fall in the last year. Most recently, the Romanian government fell and was replaced by a different political coalition. Eminent economists are talking about Greece's withdrawal from the eurozone, as the only solution for its economy to take off, grow and be able to cope with the debts already made. „In March, European leaders signed a fiscal pact that in effect locks in fiscal austerity as the response to any and all problems" writes Krugman, also emphasizing that the EU needs more expansionary fiscal policies [8]. The measures taken so far were meant to tackle the debt but not the economic crisis. This is the reason why European leaders gather in order to find a growth solution for EU and its MSs.

The inherent contradiction inside the architecture of the EMU signaled by George Soros, the lack of a European treasury, is also generating tensions. ”[The] biggest shortcoming [of EFSF and its successor, ESM] is that it is purely a fund-raising mechanism; the authority to spend the money is left with the governments of the member countries.” Soros is referring here to the bailout mechanism created in 2010. The Fiscal Pact of 2012 attaches more strings and conditions to MSs, easing this tension. The remaining question is whether these measures are enough. The tension pointed to above is certainly not addressed by the content of the Fiscal Pact.

A positive effect of the sovereign debt crisis, in terms of potential spillover and deepened integration, is that more attention is given to the conditions that may create economic growth, and these conditions are related to the free movement of labour and the free movement of services. „According to the ECB, only 20% of services provided in the EU have a crossborder dimension. A full implementation of the European Commission’s services liberalization proposals could increase EU GDP growth rates by 0.6-1.5 percentage points” [*The Future of the Eurozone and U.S. Interests*, Congressional Research Service Report of 17 January 2012, p. 18, online at www.crs.gov]. As to the free movement of labour, apart from the language barriers, the recent North African political changes as well as the economic crisis determined certain countries, like France, Germany, Italy, to take steps that come against the implementation of Schengen – a sort of involution, or ‘spillback’ Haas was talking about in the 1970s.

Another tension developed during the eurozone crisis is between the actual formal attributions of the ECB and the tasks ECB was somehow forced to assume during the past two years, due to the crisis. ECB decided on 10 May 2010 to take measures to address severe tensions in financial markets, that is: (a) to conduct interventions in the euro area public and private debt securities markets (Securities Markets Programme) and (b) long-term refinancing operations (LTROs)[22]. This decision legitimized ECB’s intervention in loan giving and buying bonds on behalf of MSs. According the Congressional Reasearch Team, “[a]rguably the most important of these measures is the ECB’s decision to purchase European sovereign debt outright in the secondary markets. This was a significant policy reversal for the ECB, which had long viewed interventions in sovereign debt markets as compromising its independence, and a diversion from its core mandate of price stability” [*The Future of the Eurozone and U.S. Interests*, Congressional Research Service Report of 17 January 2012, p. 16, online at www.crs.gov]. The tensions related to the formal and actual roles taken by ECB were exacerbated due to the opposition of the EU most economically powerful member, Germany.

Even though it is not directly relevant to the increase in supranational policy, the processes of communication, the increased number of meetings and the intense share of information that took place the entire period bear onto an increased sense of belonging to the EU, belonging to the Euro area. The policy process, resulting in about 15 ‘crisis summits’ over the past two years have contained the crisis and built a sense of the importance of working together to save the Euro. The Commission was feeding MSs' information on the state of the economy, and MSs, particularly, Greece, Ireland, Spain, Italy – have been feeding on options to work out the debt situation. Member States were acting upon the information from the Commission and upon its warnings. Sometimes, tensions were increasing between the parts, Member States were accusing EU, like minister Venizelos did – for incompetence, in august 2011.

But what are the achievements of the EU, if any, in terms of extending supranational policy in the EU, during the last two years, since the sovereign debt crisis broke out in early 2010? Following the sequences in which the crisis unfolded, including the measures and actions taken, one may notice a certain pattern: every rescue package for a country or group of countries was followed by **institutional change and an increase in supranational functions**. Thus, after the first rescue package for Greece, the European Stabilization Mechanism was set up. Actually, the ESM was set up as part of European Stabilization Actions – in the framework of which the Commission provided for "possible ECB (European Central Bank) **purchases of sovereign debt**" ['European Stabilisation Actions - the EU´s response to the crisis', online at http://ec.europa.eu/economy_finance/eu_borrower/european_stabilisation_actions/index_en.htm] – thus paving the way for ECB's increased functions. After the rescue package for Ireland was decided, in November 2010, the European Banking Authority (EBA) was set up and came into being as of 1 January 2011. A Joint Committee was created to coordinate EBA, ESMA and EIOPA – that is, the three **European Supervisory Authorities** (ESAs). The Joint Committee is not a supranational institution. However, its activity can be included in the range of supranational governance, given its main function to contribute to the cooperation of the ESAs bodies. The 78 billion euro bailout for Portugal in May 2011 was followed by another stage of institutional supranational strengthening. In July, the finance ministers of the eurozone signed the **Treaty establishing the European Stability Mechanism** (ESM). The ESM Treaty came together with specific conditionality. The state requesting assistance must implement a macro-economic adjustment programme and a rigorous analysis of public-debt sustainability, and keep in touch with IMF and ECB on these issues. The ESM Treaty was followed by a second bailout for Greece, of 109 billion euro package, conditioning Greece with structural reforms and austerity measures.

The spread of the financial crisis to Spain and Italy, determined the ECB to start **buying sovereign bonds** of these countries in August 2011 and **intervene in the secondary markets**. Subsequently, in the Fall of 2011, European leaders prepared for a bigger move. In October, eurozone leaders settled a 'three-pronged' agreement, including an increase of eurozone's main bailout fund to 1 trillion euro and the **banks recapitalization**. The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union was signed by EU members (not only eurozone) to strengthen the financial discipline throughout the Union. EBA acquires more clout and power over the banks in the eurozone in coordinating the measures against the systemic risk.

The Commission prepared and presented a Green Paper on the feasibility of introducing Stability Bonds in November 2011 – "to create new means through which governments finance their debt, by offering safe and liquid investment opportunities for savers and financial institutions and by setting up a euro-area wide integrated bond market that matches its US Dollar counterpart in terms of size and liquidity. The fiscal framework underlying EMU would similarly undergo a substantial change, as Stability Bonds would need to be accompanied by closer and stricter fiscal surveillance to ensure budgetary discipline" [European Commission Green Paper on the feasibility of introducing Stability Bonds, online at http://europa.eu/rapid/pressReleasesAction.do?reference= MEMO/11/820]. That means that the **EC is pressing in the direction of assuming more fiscal duties in a centralized manner, even if the bonds are called Stability Bonds and not Eurobonds**, as claimed by more Euro-optimists. EP also passed a resolution on the feasibility of introducing stability bonds in January 2012, pointing out (no.6) that "stability bonds would be different from bonds issued by federal states such as the USA and Germany and cannot therefore strictly be compared to US treasury bonds and Bundesanleihen" [European Parliament resolution on the feasibility of introducing stability bonds (2011/2959(RSP)), online at http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-%2F%2FEP%2F%2FTEXT%2BMOTION%2BB7-2012-0016%2B0%2BDOC%2BXML%2BV0%2F%2FEN]. It is noteworthy that European Parliament announced recently a fresh start for the frozen eurobond debate [Parliament kick-starts frozen eurobond debate, online at http://www.euractiv.com/euro-finance/parliament-kick-starts-frozen-eurobond-debate-news-512153].

The institution that evidently increased its functions over the whole period of the crisis, not uncontroversial though, is the European Central Bank. Firstly, there is no bailout clause for ECB (Article 125, TFEU). There is no provision in the Maastricht Treaty to allow the ECB to act as a lender of last resort to eurozone members in the case of a financial crisis. Still, ever since mid 2010 ECB assumed this function. According to the EMU's design, each member must finance its deficits by itself. A 'no-bail-out' clause explicitly stipulates that neither the European Union nor any member state is liable for or can assume the debts of any other member state. Secondly, there were no provisions in the fundamental treatises for the ECB intervention through buying eurozone MSs sovereign bonds and direct intervention in the secondary market.

The circumstances defined by a flawed EMU architecture and by the financial crisis put ECB in the situation to take over some supranational functions and overpass its attributions according to the existing European legal framework. It is a sign that the centripetal force of the EU is working and that the spillover effect is present in the area of EMU with extensions into the fiscal and other connected areas. The ECB has made large purchases of these countries' public debt in order to calm markets, and in December 2011 provided a huge infusion of credit into the banking system. A series of observers are now calling for more fundamental solutions, such as the issuance of Eurobonds, along with other institutional reforms that could provide a stronger fiscal foundation to the monetary union.

Some critics evaluate that „The latest reforms continue to reflect Member States' unwillingness to transfer the necessary degree of sovereignty over macro-fiscal objectives to the European level" [9]. That is to say, the functions assumed by ECB so far are not enough. A European Treasury is needed, as Soros puts it. Thus, Soros is pointing to drastic and radical changes – not feasible in EU suddenly, if we take into account the history of European construction. A more realist analyst, like Funk Kirkegaard, that „Fiscal federalism is not the answer for Europe. Rather, permanent 'fiscal conditionality' is" [6]. Or perhaps, fiscal federalism is not the answer for the moment.

6. Conclusions

There are indicators of spillover processes generated by the EMU, particularly during the present financial crisis in the EU, started in the beginning of 2010. The directions of these processes are to be found in: the institutional innovations (the ESAs, the Joint Committee) meant to contribute to a better coordination, in the possible deepening of integration in the services area (where integration is low), in the institutional development of ECB and its functions, in the Fiscal Pact that increases the EU control and supervision over the budgetary policy of MSs, in the premises created for possible issuance of Eurobonds – be they called Stability Bonds or otherwise – to name the major directions identified in this paper. The major tension facing the EU these days is the one between the urgency of adopting more drastic measures in order to assure international markets and investors that Euro is a reliable currency and economic area, and the diminished readiness of EU leaders to take measures in the direction of supranationality. Their readiness to move EMU from the monetary area into the fiscal and budgetary areas is low. It is likely that the preferred solution, in the absence of visionary leaders and/or further deep currency-quakes, will be muddling-through.

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