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Working Paper

Political legitimacy in a non-optimal currency area

MPIfG Discussion Paper, No. 13/15

Provided in Cooperation with:

Max Planck Institute for the Study of Societies (MPIfG), Cologne

Suggested Citation: Scharpf, Fritz W. (2013) : Political legitimacy in a non-optimal currency area, MPIfG Discussion Paper, No. 13/15, Max Planck Institute for the Study of Societies, Cologne

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MPIfG Discussion Paper 13/15

Political Legitimacy in a Non-optimal Currency Area

Fritz W. Scharpf



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MPIfG Discussion Paper 13/15
Max-Planck-Institut für Gesellschaftsforschung, Köln
Max Planck Institute for the Study of Societies, Cologne
October 2013

MPIfG Discussion Paper
ISSN 0944-2073 (Print)
ISSN 1864-4325 (Internet)

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Abstract

On the basis of a brief reconstruction of the causes and impacts of the euro crisis, this paper explores, counterfactually and hypothetically, whether the new euro regime, insisting on fiscal austerity and supply-side reforms, could have prevented the rise of the crisis or is able to deal with its disastrous economic and social impact. A comparison with the likely impact of transfer-based Keynesian reflation suggests that, in both cases, economic success is uncertain, while both approaches are likely to produce severely negative side-effects. In light of such dismal policy choices, attempts to politicize European election campaigns are more likely to provoke unmanageable policy conflict than to overcome the input-oriented, democratic deficit of European economic governance.

Zusammenfassung

Das Papier analysiert die Ursachen der Eurokrise und fragt dann, kontrafaktisch und hypothetisch, ob das neue, auf fiskalische Konsolidierung und strukturelle Reformen setzende Euro-Regime die Krise hätte vermeiden können oder jetzt geeignet wäre, deren desaströse ökonomische und soziale Folgen zu überwinden. Ein Vergleich mit der Alternative einer keynesianischen Politik der transfargestützten fiskalischen Reflation zeigt, dass in beiden Fällen der ökonomische Erfolg ungewiss bleibt, aber auf jeden Fall mit gravierenden negativen Nebenwirkungen zu rechnen ist. Angesichts derart unerfreulicher Politikoptionen würde der Versuch einer Politisierung der Wahlen zum Europäischen Parlament eher kaum zu bewältigende Richtungs- und Verteilungskonflikte provozieren, als zu einer Überwindung des europäischen Demokratiedefizits beitragen.

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Political Legitimacy in a Non-optimal Currency Area

1 Introduction

In spite of academic and political assertions of a “European democratic deficit,” and in spite of a steadily decreasing voter participation in elections of the European Parliament, 57 percent of all Europeans said that they “tended to trust the European Union” in September 2007 – that is, before the onset of the present crises. By the end of 2012, however, responses to the same Eurobarometer question indicated that trust had fallen to 33 percent, and distrust of the EU had risen from 32 to 57 percent (Zalc 2013; see also Roth/Novak-Lehmann/Otter 2013). But if trust was high in 2007, and if it declined steeply in the absence of any obvious changes in the democratic qualities of European governing institutions, that suggests that the understanding of “trust” that is captured in Eurobarometer surveys differs from the criteria implied in academic and political discussions of the democratic deficit. This difference is reflected in the conceptual distinction between the output-oriented and the input-oriented dimension of political legitimacy (Scharpf 1970, 1999) – between Lincoln’s “government for the people” and “by the people” or between “responsible” and “responsive” government (Mair 2009).

In normative political theory, the status of output-oriented legitimacy is primordial. The coercive powers of government are needed to attain purposes, and to deal with problems that are beyond the reach of voluntary cooperation in civil society and of market interactions. At the same time, however, these powers can be abused by oppressive, predatory, vindictive or simply incompetent governors. Hence the legitimacy of government itself is in question if it fails to serve the common good of the community and to comply with its basic norms and standards of justice. While output-oriented criteria apply to the performance of government across the board, the input-oriented norm of democratic self-government is more specific. Ideally, government action should arise from the equal participation of citizens in public interest-oriented debates conducted in a common public space. In representative democracies, that implies that governors should be responsive not only to these debates but also to the preferences and interests of all members of their constituency. To ensure responsiveness, democratic

The paper was written during my stay, from April to July 2013, at the Kollegforschergruppe “The Transformative Power of Europe” at the Free University of Berlin. I am grateful to Tanja Börzel and Thomas Risse for the invitation and the opportunity to participate in the lively and fascinating discussions among KFG fellows. A draft of the paper benefited from their critical examination in a KFG seminar and in particular from the helpful comments by Thomas Risse. At the MPIfG, my research for the paper has benefited greatly from ongoing discussions with Martin Höpner and the competent assistance of Anna Berger. A shorter version of the paper will appear in Olaf Cramme/Sara B. Hobolt (eds.), *Democratic Politics in a European Union under Stress*. Oxford University Press (2014).

political systems depend on a variety of institutional arrangements, the most important of which is the dependence of governors on the outcomes of free, equal, periodic, and competitive elections.

Critiques of a European democratic deficit have focused mainly on input-oriented deficiencies of EU political processes and institutions. But as European legislation was implemented and enforced by member-state institutions, citizens were not directly confronted with the coercive power of EU government. At the same time, member-state governments were visibly involved in EU policy making, and voters could and have used their electoral powers to hold their own governments accountable for the exercise of all governing powers, regardless of their origin at national or European levels. Because of this input-oriented “legitimacy intermediation” (Scharpf 2012), discussions of the EU’s democratic deficit have agitated mainly academic specialists and idealistic politicians, but they have not achieved high political salience. It seems plausible, therefore, to interpret the generally high level of public “trust” in the EU primarily as an indicator of output-oriented legitimacy – and of citizens’ “benign neglect” of input-oriented deficiencies at the European level.

In the meantime, however, things have changed. European economies were badly hit by the international financial and economic crises triggered by the collapse of Lehman Bros. in the fall of 2008. Subsequently, some member states of the European Monetary Union were threatened by sovereign insolvency – which was interpreted as a euro crisis. In the effort to “save the euro at any cost,” European authorities – the Council, the Commission, the European Central Bank and the “Troika” – have then deeply intervened in the lives of millions of citizens and in the economic, social and institutional fabrics of some EMU member states. In the output-dimension, these efforts have so far not succeeded in halting economic decline and the rise of mass unemployment in those states. In the process, however, they have also disabled input-oriented democratic policy choices at the national level, or have confronted national parliaments with requirements they could not reject without disavowing the commitment to European integration. In short, the euro crisis and the policies attempting to cope with it have destroyed the preconditions of “legitimacy intermediation” as the dramatic visibility, political salience, and direct effects of exercises of European governing authority have put an end to the permissive consensus and benign neglect that long characterized citizens’ attitudes toward the EU.

As a consequence, the European polity is now confronted not only with a significant decline of the output-oriented political support on which it could rely before the onset of the present crisis, but also with the much increased political salience of its input-oriented democratic deficit – which has in fact intensified in the course of euro-rescue policies. Worse yet, I will argue, the euro crisis has created a fundamental legitimacy dilemma: if the Monetary Union is to be maintained, the policies required to contain

the crisis must be of a nature and have consequences that will counteract all efforts to achieve input-oriented political legitimacy for institutions and policy choices at the European level.

But in order to establish the plausibility of these arguments, it is first necessary to examine the underlying structural causes of the steep decline of output legitimacy and the constraints of improving the problem-solving effectiveness of the Monetary Union before going on to discuss their implications for potential responses to the input-oriented deficiencies of European legitimacy. In discussing the performance of the Monetary Union, I will address the role of the original EMU regime in causing the euro crisis and shaping initial policy responses, as well as the new euro regime that has been set up to correct the effects of the crisis and to prevent its re-occurrence, and I will try to anticipate the problem-solving effectiveness of the present euro-governance regime.

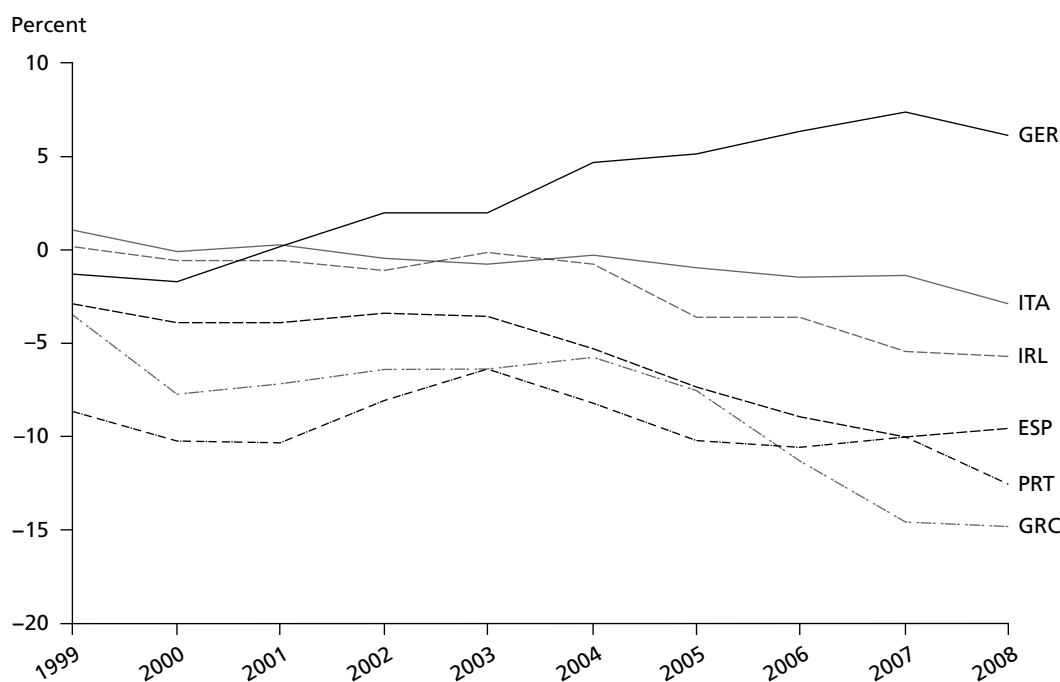
2 Performance of the original euro regime

The structural deficiencies of the original EMU regime and their causal effect on the euro crisis are by now reasonably well understood (Scharpf 2011; De Grauwe 2012; Notre Europe 2012): by joining the Monetary Union, member states lost both the need to respect a balance-of-payments constraint and the capacity to respond to problems of inflation and unemployment through the macroeconomic management of aggregate domestic demand. And though fiscal competences remained at national levels, their use for macroeconomic purposes was asymmetrically constrained by the Stability Pact and by the fact that governments could no longer issue bonds in their own currency. In addition, member states also lost the capacity of a national central bank to act as lender of last resort in case of a state liquidity crisis. Exchange-rate policy and monetary policy were centralized and exercised by the European Central Bank with a mandate to ensure price stability in the eurozone. This regime, it was expected, would reproduce for the members of the Monetary Union the beneficial effects which the quasi-monetarist policies of the *Bundesbank* had produced for the German economy (Delors Committee 1989; Commission 1990).

Centralized monetary policy in a non-optimal currency zone

It is widely acknowledged, however, that the eurozone was not then and is not now what Robert Mundell (1961) defined as an “optimal currency area” (OCA) – an economic space, that is, in which centralized policies have similar impacts on all regions. By its own logic, a monetary union of national economies presupposes strongly converging inflation rates in all member states (Flassbeck/Lapavistas 2013). In fact, however, the euro-

Figure 1 Current accounts as a percentage of GDP (1999–2008)



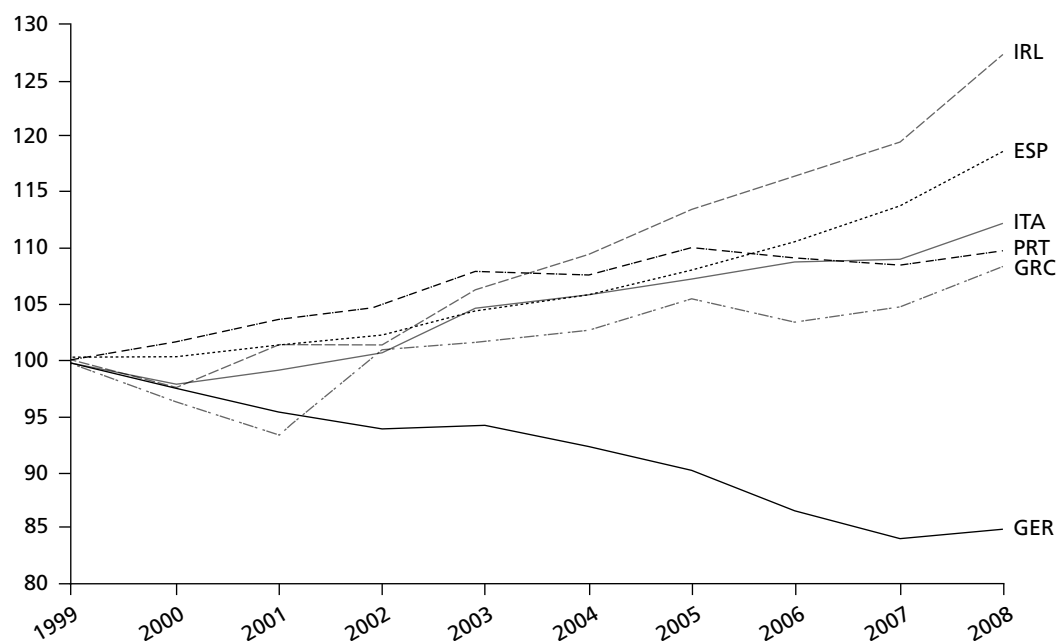
Source: Eurostat.

zone includes an extremely heterogeneous membership of former “hard-currency” and “soft-currency” economies with differing inflation dynamics driven by diverse sectoral structures, political-administrative institutions and practices and, above all, by different wage-setting institutions (Scharpf 1991; Calmfors 2001; Höpner/Schäfer 2012; Höpner 2013). Hence, even though the ECB has succeeded in maintaining low inflation rates for the eurozone as a whole, national inflation rates continue to differ systematically.¹

These inflation differences did not initially prevent the strong convergence of nominal interest rates. But they had the effect of converting these into higher real interest rates in low-inflation countries, such as Germany, and into very low or even negative real interest rates in the former “soft-currency” economies. As a consequence, aggregate domestic demand was dampened in the first group of countries and stimulated by the sudden availability of very cheap credit in the second. The resulting economic divergence was then further enhanced by the monetary impulses of uniform ECB policies – which were, of course, too restrictive for the first, and too loose for the second group of economies.

1 In May 2005, the ECB examined “Monetary policy and inflation differentials in a heterogeneous currency area” (<www.ecb.int/pub/pdf/other/pp61_77_mb200505en.pdf>) and noted that in the euro area such differences tended to persist over time, whereas they were reversed within a year or two in the United States. The article also noted that uniform ECB monetary policy could not respond to correct these national differences.

Figure 2 Real effective exchange rates (1999–2008)



ULC/Index 1999=100; EU15

Source: AMECO/author's calculations.

The destabilizing effects of monetary union on heterogeneous member economies could have been foreseen, and they were in fact foreseen by – mostly American and Keynesian – economists (Eichengreen 1990; Eichengreen/Frieden 1994; Krugman 1990; Hagen/Neumann 1994; Feldstein 1997). On the political level in Europe, these warnings had played no role as the single currency was seen as a commitment to European integration in the face of apprehensions about German unification. And they were rejected on theoretical grounds in the Commission's (1990) study entitled "One Market, One Money," which, based on monetarist and rational-expectations assumptions, discounted the effects of monetary impulses on the real economy. Moreover, it was expected that economic interaction in the Monetary Union itself would overcome the heterogeneity of eurozone economies. Reduced transaction costs would increase trade, and competition would equalize prices and discipline wage increases. At the same time, the removal of currency risks and of balance-of-payments constraints would facilitate cross-border capital flows to finance the catch-up development of relatively backward economies. In short, the benefits of monetary integration would greatly exceed the potential costs associated with the loss of autonomous exchange rates.

Many of these expectations were plausible as far as they went. But they were also incomplete. What, surprisingly, was not anticipated were the responses of rational economic actors at the micro level to the incentives and disincentives of monetary impulses – and the destabilizing effects which these would have on the macroeconomic levels. In fact,

high real interest rates did reduce the demand for credit in Germany and pushed the economy into the recession of 2001–2005, whereas in Greece, Ireland, Portugal, Spain and Italy (the GIIPS economies), domestic demand was stimulated by the sudden availability of extremely cheap credit. The ECB was not merely unable to stabilize these economies; its uniform policies actually extended the booms and deepened the recessions in the eurozone.²

In the end, Germany, which had become the “sick man of Europe” at the beginning of the decade, managed to fight its recession through a combination of union wage restraint and supply-side reforms. In combination, these measures facilitated an export-led recovery and a considerable expansion of low-wage employment. At the same time, however, the decline of domestic demand and rising exports generated massive external imbalances – increasing current-account surpluses and a progressive under-valuation of the real exchange rate. In the GIIPS economies, by contrast, credit-financed domestic demand continued to rise, and so did imports, economic growth (particularly in the real-estate sector), employment, and wages. And again, the outcome was a build-up of external imbalances – ever increasing current-account deficits and vastly over-valued real effective exchange rates that penalized exports, just as German exports were subsidized by real under-valuation.

Remarkably, however, these imbalances were not treated as a cause for concern by European or national policy makers. Rising GIIPS deficits were easily financed by capital flows from Germany and other surplus countries, and thus seemed to support the original expectation of beneficial catch-up development.³ The ECB on its part had succeeded in ensuring the stability of consumer prices and saw no justification for intervening against asset-price inflation and the real-estate bubbles in Ireland and Spain. And since the Maastricht Treaty and the Stability Pact defined obligations only for national fiscal policy (which were over-fulfilled by Ireland and Spain, and no more violated by Portugal than by Germany), neither the Commission nor national governments had a sense of an impending catastrophe. But all that changed with the onset of the international financial crisis in the fall of 2008.

-
- 2 De Grauwe (2012: 176–82) provides documentation of significantly diverging growth and inflation rates, real interest rates, and housing prices, and he also describes the divergence between the ECB rate and “desired interest rates” of individual economies defined by reference to their output gaps. But he merely concludes that in the face of asymmetric shocks the ECB may be paralyzed, rather than that its policies act as destabilizing monetary impulses.
 - 3 Even in November 2008, at the Fifth ECB Central Banking Conference, Andrew Rose (2009: 251) concluded that “the EMU has created a virtuous circle; by increasing trade and the synchronization of business cycles, EMU reduces the need for national monetary policy. That is, EMU seems along the path to becoming an optimum currency area.”

Euro crisis and euro-rescue policies

The immediate effect of the Lehman collapse was a world-wide credit squeeze which brought all economies to their knees and forced all governments and central banks (including the ECB) to revert to “Keynesian” reflation, and to save their over-extended but “system relevant” banks. Thus public-sector deficits escalated everywhere. But the credit squeeze hit hardest on those eurozone economies that had become totally dependent on capital inflows from abroad. Their economies were pushed into the deepest recession – which also meant that their public-sector debts, which had been extremely low in Ireland and Spain and no higher in Portugal than in Germany before 2008, rose most steeply thereafter. In effect, in these economies a large overhang of private-sector indebtedness was being transformed into public-sector debt. And when capital markets finally responded, the GIIPS economic crises were compounded by acute state-credit crises.

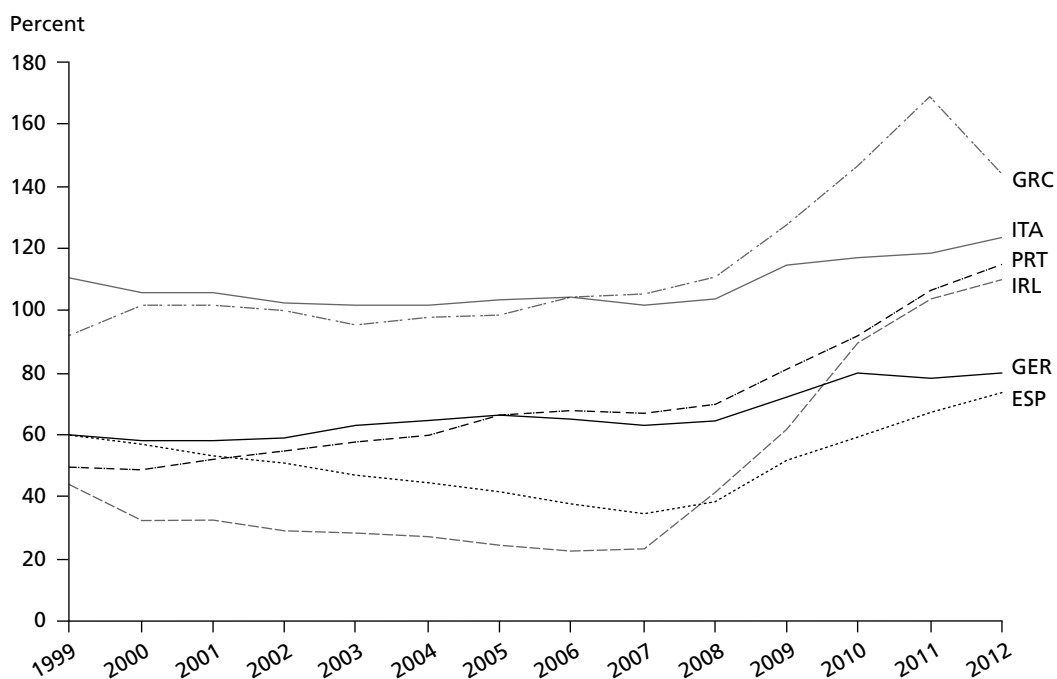
From the perspective of investors, member states of the Monetary Union were generally more vulnerable than states indebted in their own currency because governments could not defend their solvency by printing money, and because the Maastricht prohibition of monetary state financing seemed to rule out the ECB as a lender of last resort (De Grauwe 2012: 120). And within the Monetary Union, GIIPS states were the most likely targets of speculative attacks because their huge current-account deficits raised doubts about the capacity of their economies to service and repay the accumulated private and public-sector debt. Hence risk premia on their government bonds increased steeply – which, as a self-fulfilling prophecy, could quickly drain the liquidity of national budgets, raising the specter of sovereign insolvency, first in Greece, and next in Ireland and Portugal.

Once governments in Germany and other surplus countries realized that a Greek bankruptcy might trigger domino effects threatening other member states and ultimately the euro, they also had to consider how such insolvencies would affect the risk positions of their own banks which had transferred national savings and export surpluses to finance GIIPS current-account deficits. Moreover, a collapse of the euro would also have eliminated the export benefits of an under-valued real exchange rate. In this light, the commitment to “save the euro at any cost” and to disregard of the Maastricht Treaty’s “no bail-out clause” also served the national interest of the “creditor countries.”

In the end, however, the creation of budget-supported euro-rescue funds and the accumulation of “Target-2” surpluses in the ECB balances of creditor central banks (Sinn/Wollmershaeuser 2011) had the effect of transforming private-sector risks into public-sector risks which, in the case of default, would have to be honored by creditor-state taxpayers.

Moreover, as the Greek government had admitted that its deficit statistics had been fudged over the years, the euro crisis was widely attributed to the fiscal irresponsibility of the Greek and other GIIPS governments. And given this framing (which was only partly plausible for Greece and glaringly wrong for Ireland and Spain), rescue credits

Figure 3 Government consolidated gross debt as a percentage of GDP (1999–2012)



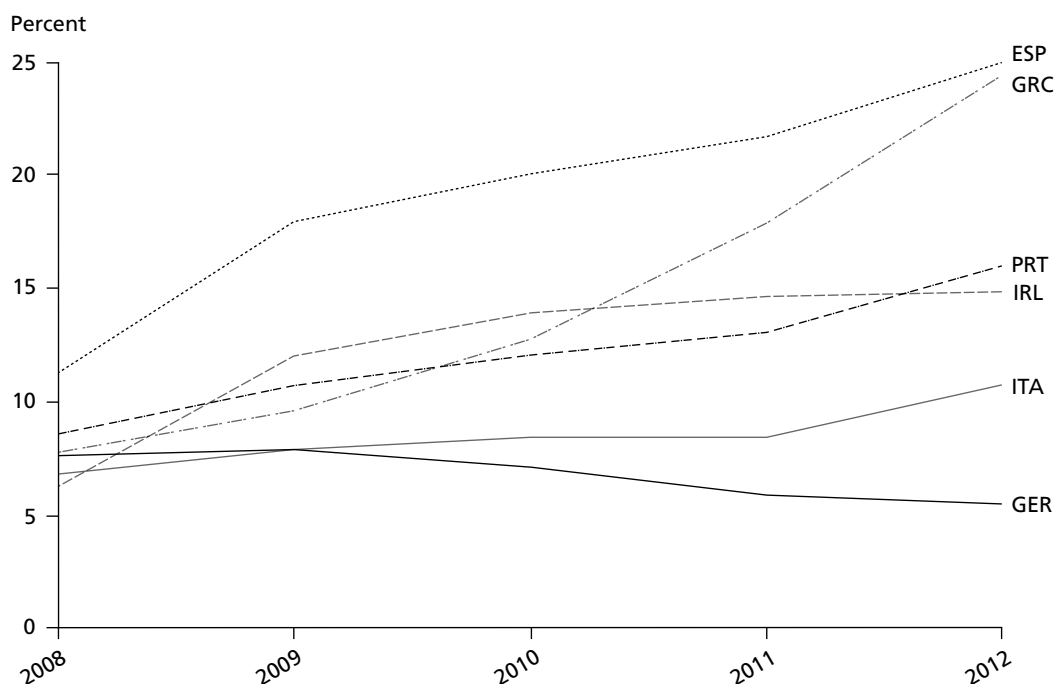
Source: Eurostat.

coming from funds backed by national contributions were provided reluctantly, hesitantly, and restrictively. And to reduce the need for further credits as quickly as possible, they were granted under rigid “conditionalities” requiring massive spending cutbacks and tax increases whose implementation was strictly controlled by a “Troika” of officials of the Commission, the ECB, and the IMF. As one could and should have expected, however, fiscal austerity in economies laboring under a deep recession would deepen the economic decline and thus increase public-sector deficits (Theodoropoulou/Watt 2012; Krugman 2013). In effect, therefore, euro-rescue policies focusing not on the state of GIIPS economies but exclusively on their state-credit problems have pushed deficit countries into a deep and persistent economic and social crisis, with unemployment rates exceeding 25 percent and youth unemployment above 50 percent in Greece and Spain, and at excessively high levels in other deficit countries as well.

3 The new regime of euro governance

In the meantime, however, at least the threat of imminent sovereign insolvency seems to have abated. But the respite from market pressures was not achieved through the succession of rescue funds (whose guarantees, seen as “too little and too late,” did not

Figure 4 Unemployment rate as a percentage of the labor force (2008–2012)



Source: Eurostat.

deter subsequent speculative attacks) but rather through the ECB's unconditional commitment to do "whatever it takes" to save the euro. In effect, the announcement that, if necessary, it would buy the bonds of challenged states through Outright Monetary Transactions (OMT) was widely seen to imply that the ECB was now able and willing to act as a quasi-lender of last resort not only for banks but for governments as well. As a consequence, "austerity" requirements are no longer defended as an immediately effective remedy for state-credit crises, but have become part of a new euro regime whose purpose is to ensure the long-term viability of the Monetary Union and which goes far beyond the previous constraints on member-state fiscal policy.

Revised problem perceptions and their implications

The perceptions governing the present euro regime were formulated by the European Commission (2010) in the brief interval between the start of the international financial crisis and the rise of a manifest euro crisis in its report on "Intra-Euro-Area Competitiveness and Imbalances." It represents an astonishing, though unacknowledged, reversal of the theory-based expectations which, in the Commission's (1990) "One-Market-One-Money" report, had justified and guided the creation of the Monetary Union.

Even though the monetarist-neoliberal paradigm remains unchallenged, the expectations derived from it have been modified radically. The belief that market forces would automatically overcome economic heterogeneity in the eurozone has disappeared. Instead, the first decade of the euro is described as a period of increasing imbalances of current accounts and dramatic losses of competitiveness in some economies – which are now seen as the main threats to the “successful and sustainable functioning of EMU in the long term.” Instead of market forces, it is state action that should have prevented these and that must now be employed to correct their effects. But since the Commission cannot question the Monetary Union itself and its constraints, it also cannot discuss their contribution to the generation of imbalances. And even though greater economic homogeneity was and is now to be achieved through state action, the potential contributions of macroeconomic (monetary and fiscal) management of aggregate demand at either European or national levels are completely ignored.

By exclusion, therefore, the Commission’s problem analyses focus exclusively on what went wrong in national credit-, product- and labor markets – and the potential remedies it considers are all located at the national level. Deprived of all instruments of macroeconomic management, governments are supposed to prevent and correct external imbalances with their remaining instruments of regulatory and taxing and spending policies:

It is therefore essential that Member States put in place an ambitious and comprehensive policy response geared at speeding up and improving intra-area adjustment mechanisms ... The policy response should be comprehensive. It should cover measures in four key areas: fiscal policies, credit markets, labour markets, and product and service markets. (Commission 2010: 3)

The main part of the report is therefore devoted to country-specific discussions and recommendations suggesting the problems that should be resolved by the governments in question.

From soft recommendations to hardened requirements

When it was presented in January 2010, however, the report had no more force than the periodic recommendations of the “Broad Economic Policy Guidelines” and the exhortations of the “Lisbon Process,” which generally had little effect on national policy choices (Deroose/Hodson/Kuhlmann 2008). But that changed radically when the financial and economic crisis turned into a euro crisis and when rescue credits – first for Greece and then for Ireland and Portugal – were to be associated with tough “conditionalities” that were to be defined by the Commission and controlled by the Troika. These included not only extremely rigorous austerity requirements but also a wide range of “structural reforms” corresponding to the recommendations outlined in the 2010 report – except that now these could be enforced by withholding the next installment of the credits that would save the state from insolvency. And while the report had merely indicated the direction of reforms in general terms, the quarterly “Memoranda of Understand-

ing” and the Troika’s compliance reports were and are concrete and detailed, spelling out which laws and regulations must be abolished or changed; which organizations are to be abolished or reorganized; which state functions and state-owned enterprises have to be privatized; which salaries, welfare benefits and minimum wages must be cut; and how many public-sector jobs have to be eliminated.

Initially, of course, these powers were available only if a member state had applied for rescue credits – as of now, Greece, Ireland, Portugal, and Cyprus and soon perhaps Slovenia. But in December 2011, Council and Parliament adopted a “Six Pack” of regulations and directives that apply to all EMU member states, regardless of any immediate threats of state insolvency. Together with the “Two Pack,” the “European Semester,” the “Fiscal Pact,” and the recent agreement on centralized banking supervision they constitute a new governance regime for the Monetary Union that extends centralized competences far beyond their reach under the rules of the Maastricht Treaty.

The regime’s most ambitious and potentially revolutionary element is the “Excessive Imbalance Procedure” (EIP) established by two regulations for the “Prevention and Correction of Macroeconomic Imbalances” (EU 1174 and 1176/2011). They extend the Commission’s supervision, control, and sanctioning powers to an undefined range of national policy areas, without any reference to the division of European and national competences. What matters is that the new powers will finally satisfy “the need for a stronger framework, and reinforced governance, including financial disincentives, to ensure that recommendations are appropriately taken into account at national level” (Commission 2012b).

Technically, the EIP uses a Commission-defined “Scoreboard” of – at present – eleven statistical indicators which, together with upper and lower thresholds, are meant to define the range of potential external and internal imbalances⁴ that will be monitored continuously by the Commission. Findings are presented in periodic “alert mechanism reports,” leading to “in-depth reviews” of economies in which imbalances have been identified. If the Commission finds an “excessive imbalance,” the next step will be “a set of policy recommendations to be followed and a deadline within which the Member State concerned is to submit a corrective action plan” (1176/2011, Art. 7.2). If accepted by the Commission and Council, the plan becomes binding. If the Commission is not satisfied with its implementation, it may propose a “decision establishing non-compliance,” which will become effective unless the Council opposes it by a qualified majority (1176/2011, Art. 10.4). The next step then are sanctioning procedures, imposing an interest-bearing deposit of 0.1 percent of GDP in the case of non-compliance, and an annual fine in the same amount in cases of repeated non-compliance or repeated failure

4 These include current accounts, capital accounts, export market shares, unit labor costs, real effective exchange rates, private sector debt, private sector credit flows, changes in house prices, general government debt, unemployment rates and financial sector liabilities.

to submit an acceptable corrective action plan. Again, sanctions proposed by the Commission can be stopped by the Council only through reverse-qualified-majority votes (1174/2011, Art. 3).

Quite apart from the decision rule disabling the Council's political control, this regime is remarkable for several reasons. First, with the exception of public-sector debt, none of the economic imbalances listed in the Scoreboard are directly under the control of national governments. It is simply assumed that they might be indirectly influenced through the use of policy instruments available to member states. Second, the regulations do not specify which national competences may be affected. Instead,

recommendations ... should be addressed to the Member State concerned to provide guidance on appropriate policy responses. The policy response of the Member State ... should use all available policy instruments under the control of public authorities. (Regulation 1176/2011 at #20)

In other words, the "constitutional" allocation of European and national competences that was achieved in the Lisbon Treaty will not constrain the domain of binding "recommendations" once the Excessive Imbalance Procedure is initiated. Moreover, the regulations provide no rules for the Commission's substantive policy choices. Since these must be country-specific and respond to highly contingent and variable conditions, they must be based on the Commission's interpretation of information obtained in its in-depth reviews. Unlike the original Stability Pact, therefore, the Excessive Imbalance Procedure is not, and cannot be, a rule-based regime. What has been set up is meant to be a legally and politically unconstrained expert regime. But that, of course, does not ensure its problem-solving effectiveness.

What if the new regime had been in place?

At the time of writing, the effectiveness of the new regime cannot yet be assessed on the basis of its empirical record. Nevertheless, one may explore, counterfactually, how it could have prevented the escalation of imbalances in the early years of the Monetary Union and, hypothetically, how it could deal with the present crisis of the eurozone. In this assessment, two constraints must be treated as given.

First, the new euro regime does not modify the fundamental deficiencies of a Monetary Union in a non-optimal currency area. In other words, nominal exchange rates cannot be adjusted, and monetary policy must be uniform for the eurozone. Given initial differences among member economies, it will thus continue to generate pro-cyclically destabilizing and divergence-increasing monetary impulses for economies with above-average and below-average inflationary dynamics (Enderlein 2004; Notre Europe 2012). And, second, the Fiscal Pact and the Six-Pack and Two-Pack regulations have strengthened, rather than relaxed, the rules preventing the use of expansionary fiscal policies at the national level. The question is, therefore, whether the policy instruments still

available to national governments (assuming that the Commission could achieve full control over their exercise) would suffice to counteract the rise of internal and external imbalances in four different economic constellations.

1999–2008: Could the rise of imbalances have been prevented?

Beginning with the problems of *overheating economies*, such as Spain or Ireland, it seems plausible that higher taxes on consumption and on wage and retirement incomes could have dampened the credit-financed rise of domestic demand. Moreover, governments could have used regulations to restrict the availability or attractiveness of consumer and housing credit. By contrast, there is little they could have done to prevent the rise of unit labor costs directly. Experience has shown that statutory wage controls in an expanding economy are bound to fail (Scharpf 1991), and the institutional preconditions under which unions and employers may be able to agree on and enforce voluntary wage restraint are extremely demanding and highly path-dependent – and they definitely did not exist in pre-crisis Southern Europe or Ireland (Höpner 2013). Moreover, the supply-side reforms which the Commission is presently imposing through its Memoranda of Understanding would have been counterproductive in the mid-2000s: the more that wage setting is decentralized and market-driven, the more rapidly would wages increase in a rising market. If wages are upwardly flexible, in other words, the rise of unit labor costs could be stopped only by the rise of mass unemployment.

Turning to the problems of *depressed economies*, such as Germany (2001–2005), declining domestic demand did reduce imports and contribute to the rise of current-account surpluses. But since monetary reflation as well as fiscal reflation through tax cuts and deficit spending were ruled out,⁵ it is not clear what the Commission could have recommended to directly increase domestic demand. Even if wage increases had been considered (Flassbeck/Lapavistas 2013), unions would have feared the further escalation of unemployment. In the Commission's theoretical framework, therefore, the only remedy would be deflation: prices would have to fall so that demand could increase in real terms.

But since market prices are not under direct government control, the effect could be achieved only by reducing the labor costs of production – which from the Commission's perspective should be considered a dilemma as it would also increase external imbalances. In any case, this is what in fact happened in Germany, where voluntary union wage restraint was combined with supply-side “reforms” that deregulated employment rules and reduced the reservation wages of the unemployed. In the end, the strategy facilitated an export-led economic recovery and the expansion of low-wage and atypical employment in services. But it also generated rising current account surpluses, capital exports, and a greatly undervalued real effective exchange rate, which of course contrib-

5 Germany was already violating the deficit rules of the Stability Pact because of the operation of “automatic stabilizers.”

uted to the loss of competitiveness of the GIIPS economies. In effect, therefore, even if the present euro regime had already been in place in 1999, it could not have prevented the rise of external imbalances.

2009–2013: How could the new regime correct the effects of the crisis?

Even if state insolvencies will be averted by the ECB's promise of OMT operations and the conditional availability of ESM credits, and even if additional banking crises should be prevented by a Banking Union, the *GIIPS economies* of the eurozone are still suffering from massive internal and external imbalances: after a deep decline, and after three years of euro-rescue operations, economic activity is still falling or at best stagnant, while public-sector debt continues to rise. Moreover, general unemployment, youth unemployment, and poverty have risen to catastrophic levels. And even though the depression has reduced domestic demand and wages, current accounts are still in deficit and, with the potential exception of Ireland, the "internal devaluation" in crisis economies is still far from approaching parity of real-effective exchange rates in the eurozone.

Under these conditions, the present euro regime will continue to insist on fiscal austerity and supply-side reforms to reduce external deficits and to improve competitiveness. As long as real effective exchange rates are significantly overvalued, internal devaluation and falling unit labor costs must be achieved by lowering nominal wages. Moreover, the Commission's recommendations seem to assume that under the pressure of mass unemployment, market-driven wages will fall more rapidly than would wages determined by collective bargaining. Hence its Memoranda of Understanding for the recipients of rescue credits have combined union-busting policies with austerity and supply-side reforms that have the effect of increasing the competition between employees and the unemployed (Scharpf 2011). If the economic and social crises nevertheless continue, it would suggest that wages have not yet fallen sufficiently to permit the expansion of low-wage employment and the export-led economic growth which pulled Germany out of its recession after 2005. In short: efforts must be increased.

Surplus economies such as Germany are not threatened by sovereign insolvency, and though their external imbalances contribute to the problems of deficit economies, they do not directly challenge the stability of the euro. So while the Excessive Imbalance Procedure seems to address surpluses as well as deficits, the Commission (2012) decided to disregard Germany's continuing current-account surpluses and the still increasing under-valuation of its real effective exchange rate. One reason⁶ might be that reducing

6 That Germany's share in the exports of GIIPS economies is quite small may also play a role, varying between 8.7 percent in Ireland and 12.6 percent in Italy in 2010, while the aggregate share of GIIPS economies in German exports amounts to 11.1 percent (OECD data). Hence the direct effect of higher domestic demand or reduced competitiveness in Germany on any one of the crisis economies might be quite small.

German competitiveness in the euro area would also weaken the eurozone's performance vis-à-vis the rest of the world. Beyond that, however, it is also hard to see what measures the Commission could actually have required to increase domestic demand and unit labor costs in Germany. Given the constraints of the Fiscal Pact, it could not ask the government to resort to deficit spending and tax cuts. It also could not ask for legislation requiring consumers and firms to save less and spend more, or requiring unions and employers to agree on higher wages in the private sector. In short, the new euro regime appears powerless to deal with the external imbalances of surplus economies because national governments lack effective policy instruments.

4 The euro regime: What is gained and what was lost?

Exit from the Monetary Union is not seriously considered by European or national policy makers and their academic advisors because it is seen to be associated with prohibitive, but largely unexplored economic and political risks. Nevertheless, it is useful to compare the problem-solving capacity of the present euro regime with the capacities member states lost when they joined the euro, if only for the purpose of illustrating the challenges that have to be faced if the euro is to be maintained.

Limited gains

Compared to the euphoria of the "One Market, One Money" campaign (Commission 1990), present defenses of the euro appear much sobered. But they still insist that the single currency has increased Europe's weight in global financial affairs; that it has greatly reduced transaction costs by eliminating internal and dampening external currency fluctuations; and that it has eliminated the temptations of competitive devaluation among its members. I will refrain from commenting on the first, quasi-geopolitical argument, but the other two deserve some attention.

Yes, the heavier mass of the euro has dampened the effects of *exchange rate volatility* on eurozone economies, but countries such as Sweden or Norway and firms serving world-wide markets seem to have learned to deal with these effects, just as tourists have learned to use cash machines when landing at Heathrow and to use credit cards in Swiss restaurants and taxis. So the benefits of lower transaction costs may not be quite so overwhelming. And yes, the members of the Monetary Union are no longer exposed to speculative attacks on their national currencies. But under the previous regimes of exchange-rate coordination (Bretton Woods or the European Monetary System of 1979–1999), such attacks were not very frequent and they tended to occur only if speculators had reason to think that a country was trying to defend an unrealistic exchange rate.

And while euro states are now indeed secure from attacks on their exchange rates, they must fear speculative attacks on the solvency of their sovereign debt, which would not occur if they were indebted in their own currency.

Instead of nominal devaluation, competitive real devaluation

And yes, the Monetary Union has definitely eliminated the temptation of *competitive devaluation* among its members. But devaluations were never popular, and governments had to admit failure if they used them as a last resort in trying to cope with a loss of external competitiveness. So one wonders how tempting competitive devaluation was and would be in political practice. What seems much more worrying, by comparison, is that the Monetary Union and the Commission's explicit precepts are forcing member states to play a negative-sum game of competitive "internal" or real devaluation when they have to deal with external deficits or with a domestic recession and rising unemployment. Even if in economic terms nominal and real devaluation were equally effective, their distributional impacts are quite different.

Nominal devaluation is egalitarian. It reduces real incomes by raising the price of imports and of foreign vacations for everybody, rich and poor. And it can be achieved by a single decision of the government or the central bank. Real devaluation, by contrast, may be achieved through union wage restraint in those countries where large, internally centralized and economically sophisticated unions are able and willing to choose and implement this strategy. Everywhere else, however, the effect will have to be achieved indirectly, through welfare cutbacks and supply-side reforms that increase the pressure of mass unemployment and competition between the employed and the unemployed. In either case, moreover, the burden falls exclusively on workers, while capital owners will benefit from measures that are meant to improve the profitability of investments.

Obstacles to the management of aggregate demand

The Monetary Union abolished the warning signal of a deteriorating balance of payments which forces countries with an independent currency to do something about the loss of external competitiveness. And long before such countries would consider devaluation as an option, they would resort to the instruments of monetary and fiscal deflation and reflation in trying to correct external and internal economic imbalances. These instruments could be employed symmetrically, to deal with recessions as well as booms in individual economies and to correct surpluses as well as deficits in their external balances. The present EMU regime, by contrast, is designed to deal with the problems of national economies only if these generate external imbalances that may threaten the stability of the euro. And it is not suited to addressing these problems symmetrically.

If the initial problem of a national economy is one of *excess demand*, leading to rising inflation and a loss of competitiveness, the Excessive Imbalance Procedure may be able to compel national governments to reduce domestic demand by raising taxes on consumption and personal incomes and by regulations that increase the cost or reduce the availability of consumer, housing, and investment credit. But to counteract the effect of pro-cyclical monetary impulses, restrictive policies will either have to be very strong, or they must cut-in very early in the upswing – which may result in business cycles characterized either by over- and undershooting or by hectic stop-go patterns. Moreover, the use of highly intrusive tax and regulatory policies for the purposes of short-term macroeconomic management will not only encounter more political resistance but will also undermine the stability of the institutional environment, which may matter for investor expectations. In short, even if they were to be effective in dampening domestic demand, the political and economic efficiency of these measures may be doubtful.⁷

Effectiveness is even more problematic, however, if the initial problem of a national economy is *insufficient demand*, associated with rising unemployment and stagnating or falling unit labor costs – which, again, will be exacerbated by pro-cyclical monetary impulses. If rising surpluses of current and capital accounts and declining real effective exchange rates are considered as excessive imbalances, the present regime rules out fiscal interventions that would increase domestic demand directly through tax cuts and public investments, and it is questionable whether a loosening of credit regulations would have much effect when the expectations of consumers and investors are negative. Thus the Commission would be unable to recommend policies that could correct the decline of imports and rise of current-account surpluses.

And if internal imbalances were to be considered as well, the euro regime would be faced with the dilemma illustrated by the German response to the recession of 2001–2005: if the country succeeds in achieving an export-led recovery through internal devaluation, its surpluses will be the deficits of others, and its gain in relative competitiveness will be matched by the losses of other member economies. And the only allowable response to a loss of competitiveness is, of course, again internal devaluation. In other words, by its own economic logic, the present euro regime creates compulsory cycles of real devaluation – which, unlike the temptations of nominal devaluation, amount to a race to the bottom that must asymmetrically depress wages and working conditions and increase social inequality in all eurozone economies.

7 Milton Friedman is alleged to have said: the advantage of monetary policy is that it is a lot easier to change the price of money than to manipulate thousands of relative prices.

Global capitalism and self-inflicted helplessness

It should be emphasized, moreover, that these asymmetric pressures are self-inflicted. They are an effect of the euro regime that has nothing to do with the pressures and constraints of globalized product and capital markets. Of course, all highly industrialized countries are affected by the rising share and increasing competitiveness of threshold economies in global product markets, and all of them will be faced with a decline of their relative – and perhaps also absolute – prosperity. But countries outside the Monetary Union may choose between accepting and moderating this decline through a gently declining nominal exchange rate, or fighting it through vigorous – and inequality increasing – efforts to defend competitiveness through real devaluation.

And of course all capitalist democracies are affected by the worsening terms of trade between labor and the state, on one side, and capital, on the other. It was brought about by the removal of barriers to capital movement, by the deregulation of capital markets, and by the rise of a type of financial capitalism that is largely disconnected from the need to make profits through employment-creating investments in the real economy (Streeck 2013). But countries outside the Monetary Union and the EU have at least the freedom to explore and invent coping strategies that would increase their ability to defend their own social and political priorities. Even sailboats, after all, may reach their chosen goals though they have no control over wind and waves.⁸ Policy makers in the eurozone, by contrast, have their responses doubly constrained by the euro regime and by the inexorable progress of negative integration and market-enhancing prohibitions imposed by internal-market rules and European competition law (Scharpf 1999, 2010).

But could the regime be patched?

In the meantime, political dissatisfaction with the present euro regime is growing, not only in the crisis economies but also among center-left political parties elsewhere and even among policy makers at the European level. Moreover, economists who are critical of the monetarist-neoliberal paradigm of the present regime have begun to explore the possibility of Keynesian remedies to the current crisis. But since the political and academic critics remain committed to defending the Monetary Union, they cannot chal-

8 Much of the pro-euro discussion on the European Left is, in my view, affected by a “powering” bias and a neglect of “coping” options. The euro is seen as a precondition for re-achieving political control over the capitalist economy that has been lost at the national level (for example, Habermas 2011, 2013). That makes it hard to accept the insight that the euro itself – and European economic integration in general – are a major part of the problem, rather than its solution. And that framing also seems to foreclose the search for coping strategies that could work at the national level.

lenge its basic structural deficiencies and functional requirements. As a consequence, their proposals must be seen as add-ons or patches to the current regime. I will discuss three of these.

The first proposal, *wage coordination*, which had played a role in Keynesian regimes before these were displaced by monetarism (Scharpf 1991), is now promoted as a solution to the euro crisis in a study commissioned by the Rosa Luxemburg Foundation of the German Left Party (Flassbeck/Lapavistas 2013). It suggests that wage setting in all eurozone economies should follow the “Golden Rule,” according to which nominal wage increases should be defined by the rise of labor productivity plus the inflation target of the ECB. The proposal resonates with the Commission’s (2010) belief that divergent increases of unit labor costs were the proximate causes of divergent competitiveness. And since uniform ECB monetary policies have destabilizing effects only if national inflation rates differ, the presumed influence of wage increases on inflation suggests that effective wage coordination might in fact remove the fundamental problem of monetary union in a non-optimal currency area. In other words, if the proposal were realized, it could greatly improve the economic viability of the Monetary Union. Unfortunately, however, the proposal fails to address at least two fundamental difficulties.

The first is that it comes too late. It might have worked if it had been adopted and implemented in 1999 when, presumably, nominal and real exchange rates were roughly in agreement among all eurozone economies – and could then have been stabilized through the Golden Rule. In the meantime, however, they have diverged dramatically. And even if the Rule were now faithfully applied not only in GIIPS economies but in Germany as well, it would, by the authors’ own estimate, take one or two decades to achieve full convergence of unit labor costs and real exchange rates. If that waiting period might appear too long, one would still be left with the Commission’s present regime of imposed real devaluation through nominal wage cuts.

The second problem is that the proposal ignores its own institutional preconditions (Sossike/Iversen 1998). To appreciate it, one must understand that wage coordination would require the Golden Rule to be followed equally, when market wages rise in a boom and when they fall in a recession. In the first constellation, that presupposes large “encompassing” (Olson 1982) unions with a centralized leadership that is powerful enough to constrain wage demands when the economy is booming and inflation rising. But union wage restraint could not be maintained unless equally encompassing employers’ associations were able to prevent “wage drift” by disciplining firms offering higher wages in a tight labor market. And in a downturn, these employers’ associations would have to agree to above-market wage increases, and together with the unions they would also have to prevent plant-level wage concessions that might save local jobs (Kenworthy 2001).

These institutional preconditions have never been fully realized anywhere, but they were approximated for limited periods in a few countries, whereas even serious efforts to create them in some other countries have proven to be impossible (Scharpf 1991; Hassel 2006). In the majority of eurozone countries, they do not exist (Du Caju/Gautier/Momferatou/Ward-Warmedinger 2008; Höpner 2013). Worse still, the Commission is presently committed to destroying the possibility of institutionalized wage coordination. In its mistaken belief that wage flexibility would ensure economic convergence in the Monetary Union, it has used the conditionalities of euro-rescue credits to disable collective bargaining agreements and to radically decentralize wage setting in the spirit of the “union-busting” campaigns launched by Thatcher and Reagan in the 1980s. In short, it seems extremely unlikely that the essentially neo-liberal euro regime could be significantly improved through attempts at Keynesian wage coordination.

The second proposal of an *anti-cyclical fiscal capacity* in the form of a “cyclical adjustment insurance fund” to be established at the European level was introduced in June 2012 in a report by the “Tommaso Padoa-Schioppa Group” of European economists (Notre Europe 2012: 30–32). It was also alluded to in communications of the President of the European Council, but then ignored in subsequent Council conclusions and in the Commission’s (2012a) “Blueprint for a deep and genuine economic and monetary union.”⁹ But the idea was taken up again in the report of the four presidents (of the European Council, the Commission, the Euro Group, and the ECB) which emphasized the need for a “common but limited shock absorption function” that “could take the form of an insurance-type system between euro area countries. Contributions from, and disbursements to, national budgets would fluctuate according to each country’s position over the economic cycle” (Van Rompuy et al. 2012: 10–11).¹⁰ In the meantime, moreover, Enderlein, Guttenberg and Spiess (2013) have specified the concept of a cyclical adjustment insurance fund in greater detail and presented a simulation study to show that transfers reflecting the differences between individual-country output gaps and the eurozone average would have smoothed the business cycles of all member economies.

The proposal is remarkable for two reasons: first, it acknowledges the existence of the pro-cyclically destabilizing impacts of uniform monetary policy – which could not occur in the monetarist-rational-expectations paradigm that governed the creation of the Monetary Union. And, second, it acknowledges the need for anti-cyclical fiscal impulses to counteract the monetary effects – which are ruled out by the Stability Pact and the Fiscal Pact. If these insights had guided the Commission’s (1990) “One Market, One

9 The Commission did demand a fiscal capacity to finance its proposed “Convergence and Competitive Instrument” – meaning financial incentives supporting bilateral contractual agreements on supply-side “structural reforms” (Commission 2012a: 21–23).

10 The report of the four presidents also mentions anti-cyclical subsidies to national unemployment insurance systems as a potential variant.

Money” analyses and the Maastricht Treaty, the euro would not have created quite the crises it did. The question is, however, whether the remedies, if they were adopted now, would also help to cope with the crises that were in fact produced.

One question concerns the relative effectiveness of counter-cyclical fiscal reflation when it conflicts with pro-cyclical monetary deflation. In German economic history, at any rate, there have been several instances in which the *Bundesbank's* monetary restraint killed the effects of the government's fiscal expansion (Scharpf 1991). But that is not the main caveat. The proposal is meant to dampen cyclical fluctuations, and it explicitly distinguishes these from structural problems in order to avoid the politically controversial implications of long-term asymmetric transfers among EMU member states. But of course the massive and persistent macroeconomic imbalances in the eurozone constitute structural rather than cyclical problems. And under the present euro regime these are dealt with through austerity requirements and supply-side reforms aimed at reducing domestic demand and unit labor costs to overcome external imbalances. In the crisis countries, therefore, the expansionary effect of anti-cyclical fiscal impulses would not only have to counteract pro-cyclical monetary impulses (at the time of writing, ECB monetary policy is considered too loose for Germany and still too restrictive for GIIPS economies), but also the deflationary effects of the austerity requirements. That surely is more than these proposals could achieve.

Going beyond that, some of the critiques imply a program of *growth promotion through fiscal reflation* that would be strong enough to counteract restrictive monetary impulses in the crisis economies. Such ideas seem to find increasing support among left-of-center political parties, unions and academics, who continue to denounce the rigid austerity requirements imposed on the crisis countries (for example, Blyth 2013; Krugman 2013). If these were merely relaxed, of course, renewed deficit spending would simply reproduce the state credit crises. So a major fiscal stimulus would have to be financed either through significantly subsidized external credit (through Eurobonds or the OMTs of the ECB) or through massive fiscal transfers from the surplus states to the deficit states. The problem is, however, that the economic impact of massive fiscal reflation, assuming its political feasibility, would directly counteract the intended effects of the present euro regime.

The present regime tries to reduce external deficits through austerity and the loss of competitiveness through internal devaluation – and it accepts mass unemployment and the rise of poverty as a necessary price, at least in the medium term. Massive fiscal reflation would definitely increase domestic demand and perhaps domestic investment. But regardless of how it is to be financed, it would again increase imports and thus reverse the beginning decline of current-account deficits. Hence the overall dependence of the economy on capital imports would rise again. Worse yet, if fiscal reflation were to be effective in increasing employment, it would reduce, or even reverse, the downward pressures on nominal wages, on which the success of the internal-devaluation strategy depends. If real devaluation were to fail, however, and if production in the GIIPS econo-

mies were to remain uncompetitive, job-creating private investment would occur only if and as long as it was publicly subsidized. Under such conditions, even the *European Marshall Plan* that is presently being promoted by the German Social Democrats could not ensure a self-sustaining economic recovery.¹¹

That is of course not meant to deny the need for substantial transfers to avert a social catastrophe in the crisis countries by stabilizing their failing health-care, education, and social-assistance systems. But it would require a very skillful (and quite unlikely) management of potential policy conflicts¹² to avoid outcomes that would condemn recipient countries to a permanent loss of economic self-sufficiency and political autonomy.¹³

To conclude, it seems that within the institutional framework of the Monetary Union, currently discussed “Keynesian” additions or modifications of the essentially monetarist euro regime could not significantly improve the short- and medium-term economic prospects of the crisis countries. Fiscal transfers would be important for stabilizing social-support systems and alleviating mass poverty, and they might also soften the impact of supply-side policies that are meant to improve competitiveness. But they are also likely to extend the period of economic stagnation and contribute to a permanent economic and political dependence on external transfers.

5 Input legitimacy of the present euro regime?

From an output-oriented perspective, in other words, the prospects of a successful resolution of the euro crisis appear dim. If the Monetary Union is to be maintained, both of the competing policy approaches – monetarist/supply-side and Keynesian/demand-side – are associated with strongly negative side effects. Worse yet, both have extremely asymmetric distributional consequences: the present euro regime imposes massive sacrifices on the deficit countries, while protecting the creditor positions and export interests of the surplus countries. By contrast, the Keynesian alternative would alleviate the misery of the deficit societies but would depend on massive transfers at the expense of

11 The success of the original Marshall Plan in postwar West Germany came after a massive devaluation of the newly introduced Deutschmark.

12 If transfers were used, for instance, to increase unemployment benefits, the increase of reservation wages would damage competitiveness; if they were to reduce employee contributions to unemployment insurance, rising domestic demand would increase current-account deficits; but if additional funds were used to reduce employer contributions, they would reduce production costs and might improve competitiveness as well as the current-account balance.

13 When East Germany was united with West Germany at a grossly overvalued exchange rate which was not corrected through internal devaluation, it took more than two decades, two trillion euros of West-East transfers and subsidies, plus a massive out-migration to raise per capita GDP in the eastern regions to about 70 percent of the Western level.

taxpayers and public services in the surplus countries. It is in the light of these dismal choices in the output dimension that the prospects of European democratic legitimacy need to be discussed.

In its present form, the euro regime's claim to acceptance depends on the output-oriented and uncertain promise that the policies pursued by the ECB and imposed by Council and the Commission will, in the foreseeable future, facilitate the economic recovery of the crisis countries, and that they will thereafter prevent the generation of new macroeconomic imbalances among the members of the Monetary Union. These choices have been taken and are presently taken in an institutional setting that provides near-perfect protection against the interference of input-oriented political processes and of democratic accountability to the constituencies affected.

The lack of democratic accountability is most obvious in the case of the *European Central Bank*, which has become a crucially important policy maker in the new euro regime. Its autonomy is institutionalized much more rigidly than was true of the German *Bundesbank*, whose authority depended on popular support and whose formal status could have been changed by simple parliamentary majority. Initially, the ECB's claim to output-oriented legitimacy had rested on the belief that its mandate to ensure price stability in the eurozone would constitute an unmitigated collective good. It was weakened by the unequal distributive impacts of its rule-bound policies on individual member states. And the belief in rule-bound monetary policy itself has been damaged by the bank's commitment to discretionary, highly visible, and politically controversial policy choices in the course of doing "what it takes to save the euro." So far, however, the ECB's gamble on its output legitimacy has not yet provoked serious proposals to subject the exercise of its potent governing powers to input-oriented democratic accountability.

In a somewhat similar fashion, the powerful role of the *European Commission* in European legislation and in the interpretation and enforcement of European law has long depended on the output-oriented – and, as Vivien Schmidt (2013) has insisted, throughput-oriented – authority of a politically independent and neutral trustee of the European common interest and of a protector of smaller member states against the bargaining power of the big ones. That authority has been undermined by its exercise of highly intrusive, discretionary, and highly divisive governing powers in the context of euro-rescue policies and of the new euro regime. And it does not really matter whether its role is now seen as that of a subservient agent of the current preferences of Angela Merkel or, as I would suggest, as the ideologically committed agent of a monetarist supply-side program: in either case, the Commission and its actions have lost the aura of neutrality and objectivity. Its policies cut deeply into the economic and social structures and policy legacies of member polities, and they conflict with the highly salient interests and preferences of national constituencies. At the same time, the possibility of political correction by the Council has been greatly reduced through the reverse-QMV rule. In other words, the Commission has assumed a role that urgently requires, but completely lacks, input-oriented democratic legitimacy and accountability.

But even if the Commission's recommendations had to be positively approved by a vote in the euro group *Council* (which would, of course, exclude the target government), they would still lack input-oriented democratic legitimacy. The votes of national ministers or heads of state and government are arguably legitimated indirectly through their accountability to national parliaments and voters. But the German electorate could at best authorize its representatives to accept sacrifices for Germany individually, or to agree to common rules that will bind all member states. But the indirect accountability of governments acting in the "intergovernmental" mode at the European level (Scharpf 2001) could not justify the imposition of unilateral, involuntary, and totally discretionary sacrifices on a particular member state and its people. From the perspective of the Portuguese people, therefore, even positive Council votes supporting rescue "conditionalities" and sanction-backed Commission decrees can in no way be construed as "self-government." They have the quality of being ruled by foreign governments.

The *European Parliament*, finally, has adopted the Six Pack regulations establishing the institutional framework of the Excessive Deficit and the Excessive Imbalance Procedures. But it did not and could not adopt general rules defining either the domain of national competences to be controlled or the type of measures and the conditions under which they could be imposed. In other words, the EP in its legislative role consented to the establishment of a discretionary authority, but it does not and could not have a role in the execution of that authority.

In short, the governing powers exercised by the ECB, the Commission, and the Council in the present euro regime are not directly or indirectly supported by institutional mechanisms of input-oriented democratic accountability. Instead, they are publicly justified by output-oriented arguments asserting their necessity for coping with the current crises and for stabilizing the Monetary Union. In the preceding section, I raised doubts about the problem-solving effectiveness of this regime. In any case, however, the legitimacy of a technocratic-authoritarian regime that depends exclusively on output-oriented promises, and whose exercise of governing powers interferes massively and visibly with the interests and life chances of millions of citizens, must be considered extremely fragile. If its performance were to fail, the impact on the political support of European integration itself could be fatal.

6 Could political union provide the solution?

In current debates it is often asserted that it was a mistake to create a Monetary Union without at the same time creating a European Political Union. What that would have meant, however, was unclear in the 1990s. And it remains unclear now, with suggestions envisioning at one extreme a fully democratized "United States of Europe" (or of the eurozone?) with a large central budget, centralized economic and social policies, and

German-style interregional fiscal equalization, and at the other extreme some formal transfers of competences to legalize present practices and some parliamentary controls to improve the appearance of democratic legitimacy for what needs to be done and is being done anyway. In other words, some see the euro crisis as an opportunity to create a democratic federal state, while others seek a semblance of electoral legitimacy to immunize the present euro regime against political challenges. But the nature of the euro crisis, combined with the nature of democratic politics, is likely to frustrate maximal as well as minimal aspirations.

The risk of politicization

The risk is most obvious for the minimalist position. At present, European citizens must suffer the impact of the crisis and of the de-politicized euro regime either in stoic acceptance or in helpless frustration. Merely greater involvement of the European Parliament would not change that because, from the citizens' perspective, EP elections do not influence European policy choices and cannot enforce the electoral accountability of European governors. But if the plans presently pursued by some of the European "party families" should succeed in "politicizing" EP elections and in selecting the candidate of the winning coalition as President of the Commission, European elections might begin to matter and political apathy might not persist.

However, if European policies were then to be perceived as matters of political choice and if political parties were to try to mobilize voters for or against such choices, the most likely outcome would be escalating opposition to the present regime, probably combined with escalating North-South and class-based conflict that might destroy the capacity for consensual decision making on which the European Union has so far depended. In other words, the present euro regime based on monetarist-neoliberal theoretical premises and on policies enforcing austerity and supply-side reforms can survive only if it continues to be protected against the direct influence of politicized mass publics. But should it survive?

That it should not survive is the hope of left-of-center and pro-European democrats. Its far-reaching ambitions are represented by works of Jürgen Habermas (2011, 2013) or Stefan Collignon (2013) and others who consider the euro crisis as an opportunity for creating the conditions of democratic self-government at the European level. Only at that level, so it is hoped, is there a chance of re-establishing democratic political control over the capitalist economy that nation-states have progressively and irretrievably lost since the 1970s (Streeck 2013). But since the loss of national control has been largely the result of liberalizing and deregulatory policies pursued by the EU (Scharpf 1999, 2010), left-of-center pro-Europeans must also place their hopes on a fundamental change of the European economic regime that is to be brought about by left-of-center majorities in a European democracy – which seems like a very long shot.

Moreover, any attempt to mobilize European voters for a left-of-center program would be handicapped by the conditions analyzed in the preceding section. The Monetary Union and its defense have created massive problems for which there simply are no “good” solutions. Even proposals for a Keynesian reflation and a “European Marshall Plan”, which a left-of-center campaign would be most likely to promote, are associated with so many risks and counterproductive side effects that it could hardly inspire the confidence of critical publics and the enthusiasm of the masses. In any case, however, once electoral politics would begin to address the euro crises and their resolution, they would also focus on the moral, legal, and economic issues of intra-European redistribution.

The moral demand is, of course, that the peoples of Europe should be ready to practice the “solidarity among strangers” that ought to arise in a political community under a common government and a common constitution (Habermas 2011). And there is indeed evidence that Europeans have come to accept the inclusion of European migrants in the redistributive social support systems of their own state (Gerhards/Lengfeld 2013). But the solidarity required in the euro crisis would of course demand much more. In fact, it might well have to resemble the West–East transfers after German unification which, for the period between 1990 and 2010, were estimated at about two trillion euros (Süddeutsche Zeitung 2012). In that case, however, the moral obligation of solidarity was not itself in dispute. And by and large, the transfers could be realized by incorporating East Germany into the existing federal and welfare-state regime of West Germany. Thus East Germans were simply included in the national pay-as-you-go social insurance system, where contribution rates were adjusted as needed. Similarly, the “new Länder” became part of the horizontal and vertical equalization scheme of German fiscal federalism, in which, after the usual haggling, contributions and benefits were modified to reflect the new relativities of fiscal capacity. Moreover, an existing income-tax surcharge was increased and earmarked for additional transfers from the federal budget. In other words, West-East redistribution could be – and largely was – treated as “business as usual” in German politics.

In Europe, however, there are no established redistributive routines that could simply be activated. Nor could solidarity simply be taken for granted. It would have to appeal to a European collective identity which, while increasing (Risse 2011; Gerhards/Lengfeld 2013), seems as yet unlikely to generate the unquestioned sense of moral obligation that could be called upon in a historical nation. Hence distributive conflicts are unlikely to remain mute. Moreover, the moral issues of West-East redistribution in Germany were much simpler than those that may arise in European controversies: given the external indebtedness of crisis countries, for instance, would solidarity imply redistribution from wage-earning tax payers to capital owners and banks in the creditor states? Or could large-scale fiscal transfers be justified as long as recipient states engaged in tax-rate competition or failed to collect their own taxes from the rich? And should obligations and benefits depend on countries’ relative performance in the eurozone, or on their relative wealth – in which case one could question the inclusion of Ireland and the exclusion of Slovakia and Estonia, or of non-euro countries, such as Romania? In

short, the choice of criteria – class-based, country-specific, economic, social – on who should contribute and who should benefit would inevitably be controversial, and so would the question of whether European policies should maximize economic efficiency and convergence or should protect the institutional and cultural diversity of European societies (Agamben 2013). If these issues were to become salient in European politics, it is unlikely that they could be resolved by consensus.

Legitimate majority rule?

If they are to be resolved politically, therefore, the EU or the eurozone would depend on majority rule – which would presuppose a fundamental constitutional revolution. In the European polity, it is true, integration has been promoted and many issues have been resolved in the absence of political consensus in a non-political “supranational-hierarchical mode” (Scharpf 2001). In this mode, the European Court of Justice and the Commission have effectively shaped European policy in areas which, in spite of their substantive significance, had low political salience (Scharpf 2010). When the European polity is acting in its *political mode*, however, its legislative procedures – described as the *Community Method* – depend on initiatives by the Commission, the agreement of national governments in the Council, and on the European Parliament. It is a cumbersome process in which agreement must be reached among multiple veto players. Even after the move to qualified-majority voting in the Council, therefore, broad consensus remains the rule and the politically salient and vigorously defended concerns of individual or small groups of member states are rarely overridden by majority votes (Häge 2013).

Given the empirical prevalence of consensual practices and the weakness of input-oriented political processes and electoral accountability at the European level, the most plausible normative concept supporting the democratic legitimacy of the multilevel European polity has been that of a European “demoicracy” (Nicolaidis 2004, 2013; Cheneval 2011; Cheneval/Schimmelfennig 2013). It locates the basis of democratic legitimacy in the member states whose cultural, institutional, and political diversity ought to be protected, rather than homogenized, by European policies. Hence the increasing externalities of national policy choices should be resolved primarily through horizontal accommodation and mutual recognition, rather than through harmonization or centralized direction.

In a similar spirit, some researchers with a comparative-politics perspective have compared the political system of the European Union to “consociational regimes” at the national level (Hix 1994; Gabel 1998; Schmidt 2002). The concept is used to explain the persistence of democratic government in polities with deep ethnic, linguistic, religious, or other politically salient cleavages that could fall apart or erupt in civil war if the vital interests of constituent groups were violated by hostile majorities (Lehmbruch 1967;

Lijphart 1968, 1999; Andeweg 2000). They persist because the political elites representing the several “pillars” or “Lager” have agreed to avoid majority decisions and to seek compromises or consensus in all matters affecting the vital interests of any one group.

In these comparisons, the European Union appears at best as a consociational regime, rather than a consociational democracy (Andeweg 2000; Schmidt 2002). Nevertheless, the analogy seems helpful because it also suggests a scenario for a future “transition to democracy” of the European political system. Comparative research on the historical evolution of consociational regimes provides examples of both instances of disintegration or break-up as a consequence of escalating inter-group conflict and instances of transitions from strict veto regimes to forms of consensus democracy that may eventually even lead to legitimate majority rule (Lehmbruch 1991, 1993; Lijphart 1999). In the positive scenario, the practice of elite consensus helps to dissipate mutual distrust among the constituent groups, and the communication of the group interests and values involved in compromise solutions will increase mutual empathy, while increased mobility and interactions will soften exclusive group identities. Eventually, then, the growing political salience of common rather than divisive interest, and political communications favoring the “inclusion of the other” (Habermas 1998) may make the transition to majority rule acceptable even for politically salient issues. There is reason to think that European citizens, at least in the core member states, among the younger generations and among the more educated, have already moved a considerable distance along this path. It was not unreasonable to hope, therefore, that EU policy making in the political mode would eventually progress beyond the constraints of the “Community Method” and of a “semi-consociational democracy” to that of a “semi-parliamentary democracy” in which majority votes would be embedded in transnational public discourse and deliberation (Peters 2003).

Unfortunately, however, the evolutionary transition to European democracy has now been interrupted by the politics of the euro crisis. It certainly has brought the peoples involved closer to each other. Not only the readers of the quality press, but also the consumers of TV news and tabloid headlines are now paying more attention to conditions and actions in other euro states than one thought possible a few years ago. But even if the initial “blaming and shaming” frame is weakening, what national publics now learn about each other is not inspiring mutual trust and a focus on common rather than conflicting interests. And what they read about interactions at the European level resembles the self-interested use of asymmetrical bargaining power more than a move toward consensus democracy or integrative leadership.

What matters most, however, are the dismal and deeply divisive policy options discussed above. There is at present no suggestion in political or academic discussions of an integrative vision that would acknowledge the common responsibility for the euro crisis while describing a plausible path to economic recovery and social stabilization, together with a fair distribution of the burdens of adjustment. Under these conditions, election campaigns could not promote an overriding common interest as the focus of

Europe-wide and pro-European political mobilization. Instead, they would have to deal with highly salient and inevitably divisive conflicts over who should suffer and who should have to pay, for what reason and how much.

Under these conditions, attempts to politicize European elections are most likely to reduce the capacity for consensual political action at the European level even further (Bartolini 2006). And if blockades were to be overcome by prematurely resorting to majority rule, policy choices imposed by Northern electoral majorities and liberal parties over Southern protests, or by Southern and Eastern majorities over Northern protests, might indeed destroy European cohesion.

In short, far from facilitating a breakthrough to Political Union and European democracy, the euro crisis seems most likely to reinforce the present non-political euro regime, combined with intergovernmental bargaining over “Keynesian patches” and social transfers. This is not an inspiring prospect. But it may be the best that is available.¹⁴

14 The outcome is, of course, not pre-ordained: in the best of all possible worlds, supply-side conditionalities might help to improve the competitiveness of GIIPS economies, while social misery would be mitigated by external transfers. But things might also go from bad to worse if the availability of transfers were to prevent gains in competitiveness and economic recovery while mass unemployment were to perpetuate the need for transfers.

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