

ORIGINS AND WAYS OUT OF THE EURO CRISIS
Supranational institution building in the global finance era

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ABSTRACT

The article describes the complex process of emergence of the Euro, led by a rather functionalist conception of supranational institution building, in interaction with financial innovation and globalization. The easy financing of public deficits and households' real estate in the early 2000s hides the structural macroeconomic unbalances generated by the Euro. This mismatch generates a quite inefficient allocation of credit across the Eurozone. The present crisis is the outcome of the cumulative and perverse spillovers between a dysfunctional division of competence within EU and member States on one side, a surrender of politics to the power of global finance on the other. The present muddling through could last until a major breakthrough opens the road to a bifurcation that might be regressive as well as progressive. This framework suggests quite contrasted possible ways out of the Euro crisis .

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INTRODUCTION

After a decade of apparent success, the Eurozone crisis came as a surprise for many analysts and experts. Since the spring 2010, they have thus deployed a lot of efforts in order to understand its origins and propose a whole spectrum of solutions in order to overcome it.

Since the turmoil in Europe has been posterior to the American and world crisis after September 2008, the severity of the threat upon Euro future can be seen, as the direct consequence of financial deregulation and globalisation. A second interpretation points out a much more precise and local origin: the successive Greek governments have been hiding the reality of their public deficits and thus permanently infringing the rules of the game i.e. the Stability and Growth Pact that limited the public deficit to 3 % of GDP. A third and more synthetic explanation states that the European crisis is similar to the Asian 1997 financial one. A bad public management was not sustainable in the context of the fix exchange rates system instituted within the Eurozone and the complete mobility of international capital. For Keynesian analysts, the main culprit is the misconception of austerity policies and their diffusion across Europe. A political economy approach states that monetary federalism is not viable in the absence of a form or another of solidarity via a common European budget.

The present article recognises that this abundant literature provides useful insights over various mechanisms that generated and/or propagated the Euro crisis. Nevertheless, all these interpretations suffer from common weaknesses: they are mono causal, static, and ahistorical. The objective of this work is to tentatively propose an overarching analysis, systemic, dynamic and historical. It is argued that the functionalist method for regional integration proposed by Jean Monnet has reached its limits: any new delegation of national sovereignty to European entities runs against the contemporary logic of domestic national policies (I). The financial liberalisation and globalisation have played a major role in compensating, but only transitorily, the institutional mismatch of the Eurozone and then they brutally revealed these inconsistencies. Under this respect, the Greek crisis has been the equivalent of the tree that was hiding the forest (II). Consequently, the way out of the crisis is much more than the return to sound and sustainable national public finances. The inability of recurring European Councils to find out an easy way out of the present turmoil derives from an erroneous diagnosis that has been corrected only during the summer 2012 (III). Many astute and innovative devices have been proposed but there is no silver bullet able to deliver a fast resynchronisation of national and European policies and the coherence of the new, diverse and European procedures. Consequently, past determinisms are largely over and this opening calls for a whole spectrum of scenarios, sufficiently contrasted to possibly capture other solutions than the present “muddling through” strategies (IV).

I. THE EURO EXHIBITS THE LIMITS OF A FUNCTIONALIST APPROACH TO EUROPEAN INTEGRATION.

There is no better example of the underestimation of the consequences institutional break generated by the Euro (Boyer, 2000; Crouch, 2000): the policy-makers have worked for eliminating the previous sources of crisis – i.e. internal exchange rate volatility –, and they even tried to anticipate and overcome some of the most likely fragilities of the new institutional design, for instance by forbidding free rider national fiscal policies. Nevertheless, they seemed to ignore that public mismanagement is not the only factor of financial fragility in the Euro-zone: the private sector and especially the banks might adopt quite risky strategies, such as fuelling a real estate boom, pushing securitization or using huge leverage effects, thus provoking a typical

Minskian financial crisis (Minsky, 1986). It is precisely that happened in Spain and Ireland. Back to 1997, the Asian crisis had already shown that very sound public finances were not a protection against massive entries of capital and then their brutal stop. Paradoxically, the cognitive reference of the builders of the Euro was more the German hyperinflation of 1923 or the 80s and 90s Latin American sovereign debt crises than the new risks associated to financial globalisation and its hype effects on the “animal spirits” in the private sector. Again the basic postulate of a “naturally” stable market economy – a convenient hypothesis for model builders – has hidden the perception of the dangerous path followed by the Euro-zone after 2003.

1. After monetary integration, the failure to build financial stability

The founding fathers had the project to prevent the repetition of the two world wars that had meant the self-destruction and afterwards the decline of the old continent (Monnet, 1976). Peace was the primary public good to be searched for: if it was impossible to get it by a Europe of the Defence, the other road was the organization of orderly economic relations between Germany, France and all other nations involved in these recurring conflicts (figure 1). But a common market supposed rules of the game in order to maintain fair competition (Fligstein, 2000): it was, elevated to the statute of basic European public good justifying a progressive and patient extension of European level competences (Boyer, Dehove, 2001).

---Insert Figure 1 around here---

Nevertheless, the process has to be re-launched with the rise of exchange rate volatility and its impact over the fairness of the competition on the Single Market. After a long period of experimentation, a growing fraction of European elites has been convinced that a common currency was necessary to continue to benefit from the deepening of inter-European trade. The strength of German representatives was to propose to extent the approach of ordoliberalism to the relations between the European Union and member states: the viability of a monetary integration, without fiscal solidarity and political union, could be warranted by the respect of a set common rules in order to prevent any opportunist national behaviour that could bankrupt the Euro-zone.

Within this “prudential federalism” quid if the rules are not followed by all? Should policy makers accept a financial meltdown just to better enforce the rules that have been violated and thus prevent moral hazard to generate another crisis Since then, the Europeans had to recognize painfully that is an evidence for North Americans analysts: it is difficult to defend the Euro in the absence of a Lender of Last Resort, with a tiny and balanced European budget and no clear political leadership.

2. The Euro crisis: the many political obstacles to a fully-fledged federalism

Actually, some experts and politicians (Goulard and Monti, 2012; Cohn-Bendit and Verofstadt 2012) propose a return to the founding principles of the European integration and they stress the necessity of a move towards a truly federalist Europe: more than half a century of transnational building cannot be wasted, the cost of a failure would be huge, including for the healthier and virtuous member-States, and actually they are quite large (The Economist, 2012). Consequently it is necessary to create a European Financial Security Agency, to back it by a budget fed with a direct taxation at the EU level, to institute a centralized control over domestic public finance, to issue project bonds and then Eurobonds to mutualise the risk of default and to design new macroeconomic tools to develop an effective policy mix in coordination with the ECB. Last but not least, under this new and coherent economic government of the EU, the ECB could then play its role of Lender of Last Resort and thus convert the Euro into a full currency, in line with the statute of the Dollar (figure 2).

---Insert Figure 2 around here---

But this dream contradicts the teaching derived from a political analysis of the contradictions associated of the Euro (Boyer, 2013). Within the European political arena and in the diverse national contexts, the decision makers are not system engineers that apply the laws of economics to propel the Euro-zone into a safer zone: they are political brokers who try to mediate diverse and frequently opposite perceptions of the Euro by each socio-economic group. Furthermore, the failure to organize a smooth way out of the Euro crisis has eroded or even destroyed any technocratic legitimacy of European entities. Quite on the contrary a worsening of unemployment and the polarisation of the society between winners-financiers, high skilled professionals...- and losers- has put on top of the agenda the issue of a return to a political control of the economy, in response to citizens demands for a more effective democracy (Levrat, 2012; Sen, 2012; Habermas, 2011).

II. FINANCIAL LIBERALIZATION FUELS AND THEN REVEALS THE STRUCTURAL UNBALANCES OF EUROPEAN GOVERNANCE

The European treaties instituted an independent European Central Bank and entrusted it to the essential and quasi unique goal of maintaining a low inflation, as monetary stability was perceived as the sine qua non condition for the credibility, therefore the viability of the euro. The fixing of the irrevocable exchange rates between member countries of the euro area was designed to promote trade between Member States and promote the diversification of financial portfolio

1. The surprising appraisal by international finance: all public debts are now equivalent from Germany to Greece

After the introductory period, marked by great uncertainty, the single currency has reached its objective to stabilize inflation at a low level around 2% a year and to anchor stable long term expectations within the private sector. The international financial community was convinced and granted, from 2002 on, the same interest rate for all national public debts within the Euro-zone. While Greece, Portugal and Spain had to pay very high very high interest rates until the late ninety, their accession to the euro offered them the same favorable treatment than that accorded to Germany (graph 1). But this complete convergence of interest rates on all public debts is due to an error of economic analysis and a misreading of the European treaties.

- A priori the Euro membership eliminates a first factor of risk since parity is fixed once and for all as soon as the drachma, escudo and peso are replaced by the euro. However, it was prudent to consider that under the EU treaties some members of the Euro could not maintain their competitiveness in the absence of periodic devaluations, that was a crucial instrument in earlier decades. Was not the collapse of Argentina currency board a neglected warning?

---Insert Graph 1---

- A second consequence was expected and it turned to be wrong: the accession to the euro would bring a quasi-convergence of inflation rates across the area. But the statutes of the European Central Bank only involve maintaining a low inflation for Europe as a whole. This does not preclude that some specialization in sectors sheltered from international competition, particularly those in southern Europe, might induce higher inflation than average. Over the years, this divergence of inflation rates is not corrected and it manifests itself through a contraction in manufacturing and tradable services, and this builds a systemic dependence upon a permanent and large entry of credit from abroad.

- However a third error in the analysis of international finance is still more puzzling since it affects allegedly quite rational actors: traders do not take into account the prohibition by the European treaties of any fiscal or financial solidarity between member countries of the euro area. Furthermore, joining the euro does not mean that public finances, for example in Greece, became as strong and well managed than those of Germany. Had not the Greek political authorities used various accounting tricks and sophisticated financial instruments to remove from state balance sheet a significant part of the public debt?

2. Beneath nominal convergence, diverging specialisations and domestic growth regimes

Many opponents to the euro anticipated that the common monetary policy, only focused on price stability in interaction with the constraint implied by the SGP, would result in European slow growth, especially for the least competitive countries of southern Europe. Actually, the opposite was observed from 2001 to 2008: plummeting interest rates stimulate home purchases, durable goods, therefore the demand in these countries. The North specializes in manufactured goods (graph 2A) it exports to the South but also to emerging economies. It thus contributes to the balancing of euro-zone external trade with a positive impact on the credibility of the Euro. By contrast, other economies specialize in domestic services, generally not tradable (graph 2B).

---Insert Graph 2A et 2B---

Consequently, a structural complementarity emerges between these two sub-area in terms of specialization, supply/demand equilibrium and flows of credit but this means divergence between high value added and high skills economies and those limited to more traditional production. This internal unbalance is barely noticed in the early 2000s, whereas the competition with new industrializing countries makes still acute this productive divide. The real estate and stock market bubbles, observed in Ireland and Spain, artificially accelerate, transiently, national growth. As domestic production systems cannot meet the boom of domestic demand, trade deficits are widening for all these countries, especially when the euro appreciates against the dollar and other currencies. Indeed, Germany, the Netherlands and other countries of northern Europe generate a growing trade surplus, which ensures the viability of the euro as an emerging international currency, but accentuates the internal imbalances within the area (graph 3).

---Insert Graph 3---

3. The ambiguous blessing of Euro credibility: its appreciation puts at risk the competitiveness of many national economies

The Euro solves internal exchange volatility but does not deal with the issue of the exchange rate regime of the common currency. In the context of external and internal liberalisation of capital flows, the ECB cannot monitor the Euro / Dollar / Yen exchange rates and simultaneously control inflation, its primary objective. Initially, the adherence to a naive monetarism led to a rather optimistic assessment : if European inflation is under-control, then the equivalent of a Purchasing Power Parity equilibrium exchange rate will prevail and warrant, quasi-automatically, the competitiveness of the Euro-zone

Unfortunately, since the 80s the trans-border flows of capital have grown largely faster than world trade and even Foreign Direct Investment (FDI). Consequently, the external capital account position leads the evolution of the exchange rate, far away from the rate that would warrant a medium-long term trade balance equilibrium and competitiveness of each domestic specialisation. From 2002 to 2008, the Euro largely appreciated against the Dollar (graph 4).

---Insert Graph 4---

This move contributed to moderate European inflation, in a period of fast rising natural resources prices and it allowed maintaining a neutral or slightly expansive monetary policy. But beneath the surface, the overall competitiveness of the Euro-zone has been adversely affected with a negative impact upon the employment in the tradable goods sectors, especially in manufacturing. The strong Euro has also exacerbated the large productive heterogeneity that was already the Achilles heel of the old continent.

- On one side, the economies that follow an innovation and export led growth pattern could cope relatively easily since many sectors and firms were at the technological frontiers and price makers. Germany and most Nordic countries have long been following this path. After implementing significant reforms, they fared quite well during the 2000s.
- On the other side, other economies rely more upon the domestic market and develop mainly via their sheltered sector (construction, services to household distribution,...) and their export sector is generally small and highly sensitive to price competition given the nature of their specialisation in standardised production in mature industries. Their deindustrialisation speeds up with the appreciation of the Euro (see graph 2, supra).

Here are the germs of the present European crisis: public finance difficult sustainability reflects largely the weaknesses of the domestic productive potential in Southern Europe competitiveness.

4. The consequences of the subprime world crisis: a brutal wakeup call by international finance in response to the deterioration of public finance

When the world economy was growing at a high rate, under the combined impact of the housing boom in the U.S. and the rapid development of China, the deepening of the internal imbalances within the euro area remained largely unnoticed by European authorities. The reversal occurred only after the collapse of Lehmann Brothers in September 2008. The sharp contraction of world trade and the radical uncertainty that block financial systems are forcing public authorities, whatever their political orientation, to launch programs to sustain economic activity and give their full support to banks and bail them out. The governments definitely wanted to avoid a dramatic depression equivalent to that of 1929-1932. Thus they let the automatic stabilizers play and the level of public debt to GDP reached high levels: international financiers considered them as alarming, as soon as a modest recovery seemed to prevent the repetition of the 1930s (graph 5).

---Insert Graph 5---

They operate then a sudden readjustment of their criteria for assessing the financial health of the various members of the Euro-zone. Greece and Portugal polarize first their concern when they realize-at last- that these two countries have steadily accumulated deficits above those permitted by the SGP quasi each year since joining the euro. This is not the case for Spain and Ireland, since their governments had maintained a prudent public finance policy, reflected by some surpluses during the years preceding the crisis. If a cautious slimming-down of the public sector might seem adequate for Greece, it is much more dubious for Spain and Ireland, since their crises derive largely from a private credit fuelled speculative boom. The soaring costs of refinancing their debt are falsely attributed to mismanagement of the state whereas their crisis is largely the consequence of the errors of private actors, embarked in the hype of a bubble. Capital flight to quality translates into lower interest rates on German debt (graph 6).

---Insert graph 6 around here---

Two general lessons can be derived from the observation of this brusque reversal of fortune, respectively about the nature of European integration and the logic of liberalized financial markets.

Firstly this “the same size for all” approach to crisis resolution shows how difficult is it for financiers and public authorities to take into account the heterogeneity of socio-economic regimes that coexist within the EU (Amable *et al.*, 1997; Amable, 2003) and how serious this handicap is in the redesign of European institutions and the compliance with democratic principles as well (Höpner et Schäfer, 2012).

Secondly a key characteristic of financial markets has to be stressed upon: their evaluations are not based on an analytical rigorous model that would seeks to understand all the factors that determine the probability of default, they are built upon highly ad hoc and subjective perceptions that oscillate between overly optimistic in good times and completely pessimist when the economy turns around. This pattern is typical of stock markets (Shiller, 1999): they display a mimetic logic that leads to this instability, the more so, the higher the degree of uncertainty is (Orléan, 2004; 2009). After failing to decide and implement a community based process, political in nature, able to enforce the Stability and Growth Pact, European leaders have delegated to the financial markets the task of disciplining member states public finances. This has been quite detrimental to viability of the Euro.

The Euro was designed to prevent the liberalization of capital from derailing the construction of the Single European market, in response to the succession of speculations on national currencies exchange rates. One decade later, global finance is now playing one national public debt against another and it has destabilized the very foundations of the Euro.

5. From the Greek to the Euro crisis: a complex web of factors and responsibilities

Facing the evidence and violence of the crisis, the academic community has final, but only retrospectively, found many interpretations for it. Nevertheless generally a unique factor is singled out. The Euro was bound to fail because monetary sovereignty has to be defended by a State (Krugman, 2012). It was dangerous for Greece to reiterate the error of Argentina and accept large debt denominated in a currency its government cannot emit (Bresser-Pereira, 2012). The Euro is under stress because the rules included in the European Treaties have been violated, it is thus sufficient to strengthen their implementation (Sinn, 2012). Other economists blame the austerity policies that prevent a recovery and a return to fast growth, and neglect that it is a powerful factor of public finance sustainability (Fitoussi, 2011). The Euro could prosper but it has to fight two enemies: the political parties that defend national sovereignty and the City (Matouk, 2012). But one of the most frequent interpretations blames the intrinsic destabilising role of an unregulated finance (Orlean, 2004; 2009).

Nevertheless, each of these scapegoat explanations only capture a fraction of the different processes that link economists’ expertise, the bargaining among member-States and Brussels and the mismatch between the time of financial markets quotation and that political deliberation. The historical dimension is also important: the Euro crisis is not a sudden single event but the outcome of the long maturation of tensions that have largely been undetected or neglected (figure 4).

--Insert figure 3 around here--

Why does the crisis start in Greece? It was the weakest economy of the Euro-zone in terms of public finance, trade balance and ability of the administration to reform domestic institutions in anticipation of the opening to the world competition. The club of old industrialised economies had admitted a far less advanced member and put the issue of unequal development inside the EU. There is a paradox: the same financiers who helped in the early 2000s the Greek State to make more palatable its public finance and then helped to sell to their clients Greek Treasury bonds, totally reverse their appraisal. On March 2010, they are brutally afraid about the dramatic state of Greek situation and the price of the related CDS sky rocketed (see graph 6 supra).

The European Council and Commission had to improvise: the no-bailing out clause, supposed to be a protection of the Euro, then becomes a liability. The international finance perceives this European malaise: unclear, too late and too little interventions trigger their recurrent anxiety. Their pessimist appraisal is the equivalent of a self-fulfilling prophecy: how could an economy in deep recession since 4 years pay 18 % interest to refinance its debt? Probably not by a new austerity program that deepens the contraction of value creation and employment, triggers social unrest and government instability! This could be called “a suicidal pact” (Stiglitz, 2012).

The alliance of an entrenched new classical theory (markets are self- equilibrating), embedded into some of the models of the ECB (Smets et Wouters, 2002), and a German variant for a moral economy (the sinners have to pay for their misbehaviour) has sealed the entry of the Euro into a systemic crisis, since all the favourable factors of the 2000s now play against the viability of the Euro.

6. A new step in the Euro crisis: the vicious circle between sovereign debt crisis and bank fragility

The ideological victory of market fundamentalists has diffused widely within business and political elites a core conception: the only sources of crisis are the public interventions that try to regulate them or governments that follow careless public finance strategies.

The European treaties embedded this conception: only the accumulation of public deficits could threaten the stability of the Euro. It is why the attention of European policy makers was initially so focused upon public deficit reduction in Greece and not so much upon the financial fragility of Ireland and Spain after the bursting of their real estate bubbles. Their public deficit that was *a consequence*, has been interpreted as *a cause*, therefore its reduction should be an imperative.

This illusion was dissipated by the subsequent evolutions: in spite of the guarantees promised to the Spanish government during the spring 2012, it appeared that some major Spanish banks were on the brink of bankruptcy, not only because they held Treasury bonds but because the non-performing loans linked to the construction and real estate were exceeding their capital. Private finance and public debt crises were now synchronized, along a perverse spill-over from one to another (figure 4).

---Insert Figure 4--

This configuration is unprecedented. During the launching period of the Euro, financiers thought that the risk concerned mainly the firms, much less the banks and not at all Treasury bonds. Since 2011, the risk over the default drastically increases, followed by that of banks and finally the non-financial firms – and not only in the construction sector – are affected by the wave of adverse expectations. A retrospective analysis of the major financial crises shows that they generally

emerged out of the progressive synchronization and process of resonance of an increasing number of financial markets (Boyer, Dehove, Plihon, 2004). The Euro-zone is undergoing an equivalent process and the contagion effects from Spain to Italy and so on... introduces a new stage in the unfolding of structural instability of the Euro-zone.

III. A SYSTEMIC CRISIS, QUITE DIFFICULT TO OVERCOME

A systemic crisis is unfolding when three features are observed. Firstly, the actors prolong their past strategies but they are no more mutually compatible and social and economic unbalances develop instead of being reduced. Secondly and consequently the past institutional order is decaying and circumvented and loses its structural stability. Thirdly since the institutional mismatch becomes clearer, actors develop various strategies and alternative projects in order to build new coordinating mechanisms that would potentially delineate a new set of institutional forms. But given the complexity of modern societies and the radical uncertainty typical of a systemic crisis, no single collective actor has the power to rationally design and implement a new socioeconomic regime that would prove to be viable and resilient in the long run. These criteria derived from the analysis of past major crises within Régulation Theory (Boyer, Saillard, 2000), are fulfilled for the Euro-zone since 2010. Its crisis is not local and transitory but global and long lasting.

1. The paradoxical consolidation of the contradictory national visions

The subprime crisis should have been the day of reckoning for new classical macroeconomics and mathematical finance. It was a call for a clear aggiornamento and some lucid and bold actors should have stated: "We went wrong, let us reconsider our vision, analyses and strategy". Quite on the contrary, pro and con the Euro, declared "We were right!"

- When the Euro crisis burst out, many northern Europe analysts declared "Greece should not have been admitted into the Euro-zone it is sufficient to correct this error and Euro will be viable again."
- "Let us strengthen the SGP into a Golden Rule and enforce strong and automatic sanctions. Then the Lisbon Treaty will be sufficient again and Greece could stay in the Euro zone." That was the reply of German authorities.
- Not at all, replied another group led by French economists: "the issue at stake is to build an explicit coordination of economic policies that would promote a faster growth, only solution available for overcoming the sovereign debt crisis. Let us increase European structural funds to build infrastructures and promote innovation."
- "This is quite dangerous for national sovereignty and democracy: let us go back to a full control of money and public spending policies at the Nation State level". This vision is emerging in the societies that are suffering from the adverse consequences of austerity programs, Greece, Portugal and Spain but this opinion is spreading within quite any member of the EU, especially in the UK.
- "No! In the era of globalisation only the march towards a European fiscal and political federalism can deliver a viable solution" says another group of economists and politicians who have traditionally defended an ever closer integration.

This impressive resilience of these contradictory interpretations of the same events does contribute to the muddling through observed in Europe since 2010. The primacy of inter-

governmental bargaining still shapes the political processes: each Head of State brings along his/her national conception of the desirable economic, social and political organisation of Europe. Conversely, the European Commission has long been silent whereas its primary role is in the defence and promotion of European integration, as a common good that transcends national interests. In retrospect, the rebirth of Europe after WWII was the outcome of a shared vision, in full breach with the violent nationalist confrontations of the past: an equivalent shift has not yet taken place in response to the most severe crisis of the European integration since its inception.

2. Persist in the error: continue and strengthen austerity policies

The primacy of a priori representations has also a role in the precise design of measures decided for overcoming the sovereign debt crisis. If the only sources of disturbance are irrational and ideological public interventions, let us promote a government by experts able to cut public deficits and the economy will again converge towards its “natural” full employment equilibrium.

This is the broad – and probably unique – justification of general public budget cuts, reduction of welfare and decreases in wage. Actually a more analytical approach of the various mechanisms involved – crowding in effects, Ricardian equivalence, competitiveness improvement and effective demand evolution – shows that a set of precise conditions has to be fulfilled for austerity policies to deliver the expected positive outcomes (Boyer, 2012). Ireland might possibly belong to the virtuous configuration, but for sure Greece, Portugal, Spain and Italy do not. Their public debt / GDP ratios have continuously deteriorated since the austerity turn of their economic policies, because the Keynesian adverse effects have overrun the classical competitiveness effects (Krugman, 2012; 2013).

A pragmatic Minister of Finance should deduct from this breach between anticipated and realized outcomes that the policy has to be reassessed, probably stopped and replaced by another one. It should also ask his/her macroeconomists and econometricians to work out a new generation of models with better performance and reliability. Similarly, the search for more labour market flexibility is pursued relentless since the mid-80s and it is reactivated after 2008 but the successes are quite rare indeed. Germany is a possible exception and it took a decade to manifest itself in the context of a booming world economy, and this permissive factor is no present. .

Strangely enough, experts and politicians continue to stick to their past representation and policy (Artus, 2012c; Stiglitz, 2012). This is a bad prognosis for the success of the rescue of the Euro.

3. A succession of erroneous diagnoses, a permanent underestimation of the severity of the crisis

At the origin, the Greek crisis was perceived as a simple matter of dissimulation of the reality of public finance and bad public management: the concern was local and highly idiosyncratic. Unfortunately, the reversal of international finance expectations propagated the crisis from Greece to Ireland and Portugal. Some European experts then thought that this irrational contagion should be stopped by a re-regulation of finance, the interdiction of short selling, a public control over rating agencies at fault and possibly the taxation of capital flows at the Euro-zone level. Few anticipated that this was the beginning of a continent wide crisis.

Then from the end of 2010 to the summer 2012, European policy makers have progressively, but slowly and reluctantly, recognized that the European Treaties had not anticipated such events and gave no tools for stopping the loss of confidence in the future of the Euro. Furthermore,

probably in order to shape positive expectations, they consistently downplayed the seriousness of the current unbalances that were threatening the cohesion of the Euro-zone.

Firstly, European headquarters persist in thinking that the ailing economies are only facing liquidity shortages and not at all a possible insolvency crisis. From the start, this was a huge mistake in the case of Greece. Secondly, the primacy was given to a purely financial strategy, with a complete neglect for the real economy disequilibria i.e.: the structural gap in competitiveness of Greece, Portugal, and the inter-industrial unbalances in Spain and Ireland that suffered from large and persisting overcapacities in the construction sector. Thirdly, the problems were perceived as the consequence of a transitory shift out a stable equilibrium, it was easy to return to, not at all as deriving from the progressive convergence of adverse processes unfolding from public finance to banks, from banks to economic activity and so on...Fourthly, the authorities have long been thinking that they were fighting a series of local and a priori disconnected crises, whereas they were pieces of the systemic crisis of Euro-zone institutions and governance capacity. Lastly, the impatience of financial markets has permeated the political arena and policy makers have constantly underestimated to time required for overcoming a structural crisis: not months or years, but probably one or several decades.

This is the time horizon required for readjusting the productive specialisations, re-localising activities within Europe, building the human competences to fight efficiently against long term unemployment and reaping the benefits from labour market and welfare institutions reforms. It takes also time for organizing the democratic deliberations both domestically and in the various European Agora, in order to make intelligible and legitimate these reforms. Consequently, European level decisions have been late, partial, limited in scope and they failed to anticipate the next stage in the unfolding of the crisis. The 28-29 June 2012 European Council is more anticipatory, but its implementation faces another difficult issue: when will it be finally applied and will the financiers be patient enough?

4. Slow deliberation of European authorities, fast and imperative moves of international finance

Many new procedures were decided in the summer 2012, such as a European financial supervision of banks, the conditions for activating of FESF and future ESM and the agreement for sustaining not only Treasury bonds market but also banks capital. They have to be approved by 17 member-States and follow the institutional path specific to each country and this takes time because national Parliaments and Constitutional Courts need to deliberate and they have their own agenda and schedule. In between, the process of ratification may derail...and the international financial markets immediately incorporate this possibility in their valuation of CDS, and the interest rates in the refinancing of public debt and stock market valuation of banks.

Policy makers nowadays suffer from a large bargaining disadvantage: financiers strike first due to their access to world markets permanently open, and governments have too react, but they have to take into account all the constraints that limit their reactivity in terms of laws, regulation, taxation, public spending and welfare (Boyer, 2011). Given this unbalance generated by the different temporalities of polity, economy and finance, the only public actor able to respond quickly enough is the central banker, since he can give access to credit and liquidity to banks under pressure and intervene in the secondary markets of public debt of different maturities. Nevertheless, these interventions are buying time since only liquidity issues are addressed at and not directly all that concerns long term public finance sustainability and growth prospect.

This disadvantage of political deliberation over market price formation is still exacerbated at the level of supra-national institutions, since possibly conflicting interests and conceptions have to be

converted into a common decision. This takes time and may deliver weak responses and ambiguous compromises, interpreted quite differently by each government. Facing this uncertainty about the effective European strategy, financiers take the lead and actually they are the last resort referee and collectively they decide whether the rescue plans are credible or not. The founding fathers of Europe had not such a constraint, in the epoch of segmented, highly regulated national financial systems.

Clearly, the removal of the public control over finance has first be interpreted as a positive contribution to the emission of Treasury bonds at better conditions than within the previous limited national financial system. Nevertheless, progressively the financial assets have been sold to agents, all over the world, that only care about the return and security of their portfolio and no more to citizens whose fate is linked to the same territory as the issuers of bonds and securities. This is one of the reasons for the return of crises of sovereign debt since the governments can no more easily call citizens to buy Treasury bonds for patriotic reasons, because their savings are now managed by large institutional investors that permanently optimize the return of their portfolio over a complete range of assets across a wide sample of national economies.

Thus, the governments have freed the spirit of finance, thinking that it will be its loyal servant but, afterwards they are unable to put finance back into the Aladdin's lamp. Partly, the troubles in the management of the Euro crisis derive from this shift in the balance of power between public immobile entities and private highly mobile actors with very deep pockets.

5. The Rawls' veil of ignorance is no more available for renegotiating an adequate, effective and fair European Treaty: losers and winners are known!

Let us imagine that all the policy makers and citizens involved into European discussions about the redesign / re-foundation of the Euro area consider that once an agreement is reached, they would be stochastically allocated to one or another of the member-States (Rawls, 1971). No doubt that they could rather easily agree upon the principle of fiscal solidarity among the EU territories and they could institute for instance an unemployment benefit at the European level and an institutionalized fiscal arrangement in order to equalise the standards of living across the members of such a community. Basically, this would be the relevant measures for building a sense of a European identity and related procedures exit in typical federal states.

This is not at all the current situation in the EU. In spite of the common currency, the intra-European mobility of persons belonging to Schengen area and specific academic programs such as Erasmus, the poor turnover in the elections to the European Parliament and the very rare multinational demonstrations in Brussels, Strasbourg,...or Frankfurt suggest that a progressive building of an European citizenship has not yet taken a sufficient momentum to influence significantly the resolution of the Euro crisis. The present federalism from above – top down – is not a substitute for grass roots foundations for a European political agora.

If we leave the domain of political philosophy, in the real world the agents negotiate rules that they think fair, especially when and if they benefit for them. Therefore the two conceptions of social justice- respectively adhesion to values and principles and consequential approach – do I gain if I follow them? – are permanently inter-wined in European negotiations. The South defends an extension of the solidarity from the national to the European level, whereas for the North this means permanent and large transfers that governments have to impose to a reluctant domestic public opinion, since many citizens have born, in the past, large costs of welfare and public service reforms, both in Nordic countries and in Germany after the reunification.

This is a long lasting obstacle towards any European integration deepening. Furthermore diverging real economies trends generated by the Euro have been making compromises still more difficult. A new sense of solidarity cannot emerge in the context of the resurgence of old “clichés” about national identities and past conflicts. More generally, many contemporary federations experience a rise in the demands of the wealthier states / provinces to keep a larger fraction of revenues they generate and to reduce the size of institutionalized redistributive arrangements. It has recently been the case in Germany. Why should Northern European societies share income and wealth with still far distant populations, under the pretext that, in the past, they have been trading with them and prospering from their mistakes? This old functionalist argument to justify a closer and closer integration does not convince any more public opinions. In a negative sum game, defection is a rational option and strong nationalist political movements are here to exploit and abuse from this option.

6. A recurring dilemma: announcing how to prevent the next crisis while exacerbating the present one

The financiers are quite demanding: they ask for a stable public environment in order to be able to get the better trade-off between security and rate of returns. The rather short sighted interventions of European policy makers deliver precisely the opposite and this might explain the recurrence of short periods of relief after each European Council meeting and some days or months later, the return to a negative appraisal, since these measures do not propel the Euro-zone out of the crisis.

But there is a deeper reason for these recurring disappointments of financiers and national public opinions. As time elapses, the public authorities have understood that they have to correct the structural weaknesses of the present European Treaties and the financial regulations. But in the process of governing favourable medium-long term expectations, each decision might make the way out of the present turmoil crisis more difficult (figure 5).

For instance, in retrospect it was a major error to sustain unconditionally the financial sector: the stakeholders of the various entities kept their capital intact, the CEOs and top management cashed their bonuses, stock-options and golden parachutes, whereas the tax payers were asked to rescue the whole sector, in the name of the public good nature of a resilient payment and credit system. This decision was taken in reaction to the fear of a complete economic collapse. These bailouts arouse first the indignation of a large fraction of public opinion and second it has been preparing the seeds of the next crisis: why should bankers revise their risk assessment methods and reduce their appetite for larger and larger gains. Since some entities are too big or too interconnected to fail, they are sure to be bailed out again when the next crisis will burst out?

Policy-makers took the decision that the next-financial contracts should include clauses where by loses to shareholders will be imposed before the State could eventually recapitalize their bank. The re-negotiation of the Greek public debt was a good opportunity to make clear this principle and to finally impose a large haircut to the investors that had taken the risk to lend to such an unreliable debtor. In reaction, the spreads over any treasury bonds have increased, because the potential loses in case of non-payment are structurally higher. Unsustainable spreads have thus diffused from Greece to the rest of ailing economies, including now the larger size ones such as Spain and Italy and they have made still more painful the muddling through the crisis. To comply with these extreme financial conditions, new public spending cuts, public servant remuneration and welfare reductions had to be announced. The outcome was the progressive entering into a new recession for most members of the Euro-zone during the summer 2012: the tax basis was contracting, and UE unemployment reached unprecedented levels. In the early 2013, this recession and vicious circle is unfolding and it is, at least partially, generated by the praiseworthy

intention remove one of the mechanism that led to the crisis and to convince that it will eradicated in the next reformed configuration.

----Insert figure 5 on a full page around here--

The same unintended consequences occurred with many other statements and measures: mutualisation of debt by emission of Eurobonds, buying of Treasury bonds by the ECB, strengthening of fiscal discipline, transfer to EU level of the financial regulation (figure 5, supra). These proposals possibly design a coherent future European system, but they trigger major doubts about their ability to reverse the present downwards adjustments. Paradoxically they tend to make them more powerful.

7. Irreconcilable objectives of a complex web of actors: the origin of recurrent vicious macroeconomic circles

All the previous weaknesses in the Eurozone decision process boil down to a common and deeper origin: instead of an explicit economic government (Boyer, 1999; Boyer, Dehove, 2001), the successive European treaties have organised a complex governance implying a multiplicity of entities and actors with partial objectives and interests. This configuration seemed roughly compatible during the credit and public deficit led-boom period, but that have become self-defeating once the realism of the architecture of the Euro has been challenged by international finance (figure 6).

A constant feature emerges from the evolutions observed since March 2010, date of the reversal of economic policies towards austerity: international finance is the Stackelberg leader in the European governance game, since its expectations set the amplitude of the spread to be paid for the refinancing of each national sovereign debt. The various European Councils discuss the creation of successive public funds in order to provide a transitory relief by refinancing at lower interest rates, because they understand that the excessive pessimism of private finance would mean the march to default for economies such as Spain and Italy. But the German and Nordic governments absolutely want to block any moral hazard prone configuration and they ask for a control over the effectiveness of the adjustment programs of these economies. This means new austerity measures, on top of the ones already decided.

This derives from the fact that even after the announcement of a decision, the process of implementation remains uncertain: on one side, the national Parliaments have to approve the participation to FESF and the future MES, but on the other side, the governments that benefit prospectively from these funds face increasing difficulties when their austerity policy does not reverse the downwards macroeconomic evolutions: many social groups (civil servants, unemployed, beneficiaries of welfare transfers...) vocally oppose to the unfairness and ineffectiveness of the policy. In Southern member states, governments suffer from a form of schizophrenia: they absolutely need the help of Europe, but they are unable to convince their public opinion that the conditions imposed are useful and legitimate.

International finance does not like this ambiguity and then castigates these governments: a new wave of pessimism starts. A fourth actor has potentially, if not legally, the ability to counteract, at least transitorily, the explosion of the spreads for State and banks refinancing: the Central Bank. The US, UK and Japan have massively used this instrument and they succeeded in lowering the interest rate, thus easing the stress upon the banks and public finance. Unfortunately, the letter of Lisbon Treaty forbids this traditional role of Central Bank as an open lender of last resort. Therefore each government realizes that the Euro has become the equivalent of a foreign currency. Consequently, the unique objective attributed to the ECB – to conduct a monetary

policy maintaining a low aggregate inflation rate – is blocking one of the easiest solutions for monitoring the interest rate paid on sovereign debt.

Finally here comes the less influential actor: the European Commission, allied with the ECB and IMF, has the rather limited task to monitor the national programs of adjustments for the governments that have benefited from European funds. This conjunction of actors' strategies triggers a new sequence in the macroeconomic vicious circle that started on March 2010, under the pressure of international finance.

---- Insert figure 6 around here on a full page----

This process was stopped only once: when the ECB stated that the threat of bankruptcy of banks (and governments) was blocking the credit channel in the transmission of monetary policy to economic activity. Therefore, the ECB was entitled to buy Treasury bonds from Greece, Portugal, Spain, and Italy. This creative interpretation of the Lisbon Treaty was interrupted by the protests of the Bundesbank and the inability to get a unanimous support within the ECB Council. Immediately the adverse macroeconomic evolutions manifested themselves so powerfully that Mario Draghi had to announce in July 2012, that the Euro would be defended by any means available (Draghi, 2012).

There is no better evidence for the central prognosis of the present article: if all the entities involved into the governance of the Euro stick to their traditional objectives, past strategies and instruments, no way out the Euro crisis will emerge. But fortunately this is not the only scenario.

IV. THE END OF THE EURO OR A UNITED STATES OF EUROPE? A FUTURE WIDELY OPEN TO CONTRASTED CONFIGURATIONS

Many economists involved in the contemporary discussions about the fate of the Euro look like the trader of the movie “Margin Call” who confesses to his CEO that he was a rocket scientist before entering recently into the profession of quants, i.e. the specialists in mathematical finance: basically, they consider that the Euro trajectory is largely deterministic and can be forecasted with accuracy. Game theory is a more adequate tool since the future is widely open upon possible strategic moves from some key actors. According to the collective entity that will take the lead, contrasted scenarios could unfold and no external observer can now predict which path will finally prevail. The exercise in rational mechanics has to be replaced by another, more fuzzy and open exercise: building scenarios where on eor another leading actor might change the rules of the game at his/her benefit – and open or not – a way out of the crisis.

1. The North / South grand divide

If European citizens decide to reclaim back their democratic rights against so called irrevocable “external constraints” originating from the globalisation of production, capital and finance, and/or from the EU regulations and directives, they might conclude that, given the urgency, it is too late to ask for a democratisation of the distant European governance and to use the EU as a lever for overcoming the present crisis. The national territory thus appears as the convenient arena to win back a significant autonomy in economic matters. But such a move could well have the consequence of provoking the split between Northern and Southern Euro, since the socio-political logics at work are at odds (figure 7).

---Insert figure 7 around here---

Each item of the European agenda is interpreted differently. Legal rules are absolute imperatives and the very foundation of the society on one side, they are simply the starting point for interpreting and adapting them on the other. This discrepancy explains the drift away from the effectiveness of the Stability and Growth Pact and probably the misfortune in the implementation of the more restrictive fiscal compact and its Golden Rule decided in the summer 2012. Most social groups have access to the deliberations around the orientation of socio-economic reforms in the North, whereas in the rest of Europe, the alternation of political coalitions means a significant instability and recurring disputes about the legitimacy of markets and capitalism.

Consequently, within the first group, some major reforms can be decided and rather smoothly implemented but they need the long duration of a democratic deliberative process. On the contrary, within the second, hasty reforms are decided by a new government, but large demonstrations in the street can block their implementation and effectiveness, and the next might well cancel these reforms. Clearly, the first configuration is better equipped for responding successfully to the challenge of globalisation and Europeanization.

In the realm of economic specialisation, both regions do not compete within the same segment of the world economy. The first group has a long experience in being at the forefront of technological frontier with a high skill – high value added specialisation in some highly demanded sophisticated goods. The second is more domestic consumption led and oriented towards more traditional goods and services, largely sheltered from foreign competition. Consequently, their coexistence under the same exchange rate implies chronic trade surpluses on one side, large deficits on the other. If the credit from competitive to the uncompetitive zones stops – the case of Greece- and a fiscal solidarity cannot be implemented, the chances for continuing to share the same currency are quite limited. Thus the creation of at least two Euros might be considered as an option. After a painful period of adjustment and possible default, a return to a fast growth of the South could reconcile economic growth with the fulfilment of the social demands of citizens – reindustrialisation, job creation, preserving of the education and health systems –. In the long run, a return to a real convergence of standards of living could then allow to, possibly, share again the same Euro, but with totally different entry exchange rates and renewed national “regulation” modes.

Politically, such a scenario is not absurd: is not a majority of the population in the North against prolonging permanent transfers to the South? The citizens in the South declare that they wish to stay in the Euro-zone...but they want also the austerity programs to stop. Will not the second argument finally prevail against the first? Of course, a disorganized and chaotic disbanding of the Euro is also possible, along with the complete renationalisation of economic policy.

2. Abandon the illusion of a silver bullet: any partial reform is unable to overcome the Euro crisis

Many measures have been proposed to restore the viability of the Euro. It might useful to summarize the arguments presented and compare the respective economic efficiency and political feasibility of each proposal (table 2).

Only general remarks are developed here. First of all, the various proposals respond to a specific phase in the unfolding of the crisis, they rarely address to the structural factors behind it, even though this shortcoming is corrected by the June 2012 compact. For instance, a better control of finance is welcome, but it would not be sufficient to stop the march to the abyss that the current austerity programs, unconsciously or intentionally, are triggering. Secondly, the poor achievements of the Open Method of Coordination should convince the Europeans that a

benchmarking based on shaming and blaming is not a tool able to cope with the challenges addressed to the Euro-zone.

---Insert table 2 around here---

Thirdly most proposals – with the exception of the inclusion of a growth strategy into the June 2012 European Council decisions – focus exclusively on pure financial matters: they deal with the symptoms, not the causes of the present turmoil. For instance they neglect all the structural unbalances that make the muddling through tactic so painful: large overcapacities in the construction sector and inertia in the competences of the labour force in the economies victims of real estate bubbles, overspecialisation in equipment goods and business services in the North that can no more be sold to the South, in the context of a deceleration of the world economy. Where is the engine of growth of the EU? The successive European and world summits rhetorically mention green technologies and the fight against climate change, but quite few governments are actually able to make them an engine of recovery.

The more important failing of quite any proposal is to neglect the necessary *complementarities* to be reorganised between the European and national levels, the financial strategy and the recovery of productive investment, the short term reduction of public finance unbalances and the long term strategy of RD and permanent up-scaling of skills, the monetary policy and national budget and, tax policy choices and so on. Institutional economics and “regulation” Theory suggest that the creation of coherent *institutional architectures* is frequently an ex post discovery and the formation of political alliances, under the hegemony of a leading collective actor, might help in the emergence of these complementarities.

3. A multiplicity of possible bifurcations in European integration: leadership wanted!

If the vicious circle previously described is not to be repeated and deepened (figure 6, supra) some of the key collective actors have to accept to alter their objective and conception of their interests and then to use of all the instruments available in order to recreate a structural complementarity in the architecture of European and national economic institutions and policy regimes. Just for analytical simplicity, we will restrict the study to configurations where a single actor has the power to influence, at least partially, the objectives of others, letting open the circumstances under which such an asymmetry of power can be created. The same methodology has been applied to the possible redesign of financial regulations: for each distribution of power between States and international finance, some options are excluded but others are feasible with a variable degree of likelihood (Boyer, 2011). Here impulses and reconfigurations can originate successively from a prolonged the domination of finance, a vigorous *aggiornamento* in the conceptions of the ECB, a late but powerful return to Jean Monnet’s community approach and finally an European Spring, during which citizens would try to defeat a technocratic and elitist European Union in order to build another one (table 3).

- If *global finance* continues to lead the course of action and faces a divided and indecisive European Council and a silent Commission, the breaking-down of the Euro is quite probable and the speculative attacks will finally affect all members. Facing the urgency, many members will default, thus they will be cut off from international finance and the return to a national currency will be perceived as less detrimental than a prolonged belonging to the Euro. Some governments might be tempted to follow the default – devaluation – renationalisation strategy followed with some success by Argentina, but the contagion may make this radical move quite risky. Even the powerful economies, unable to cope with a large appraisal of their currency in the absence of strong capital controls, might suffer from the breaking down of the Euro.

- Among the distribution of roles within the European governance, *the ECB* is the only in position to possibly counter such a brusque collapse of the Euro, because a central bank has the capacity to intervene upon financial and exchange markets on an everyday basis. But at best it can buy time for the other EU institutions and national governments to make the reforms necessary to correct productive imbalances, to warrant the long term financing of welfare and to return to a more dynamic growth pattern. But one may expect a strong opposition from monetarist orthodoxy believers, that could be overcome only if the ailing economies form a new alliance and invoke “a too big to fail” argument in their negotiations with the healthier ones.

---Insert table 3 around here---

- The *European Commission* (EC) may exploit the division and ineffectiveness of the European Council, unable to mediate the conflicts among the national States, and the growing distrust about finance and its excesses – insider trading, frauds, sky rocketing remuneration, absence of contribution to real economy recovery. The EC, headed by a visionary and charismatic president, could thus take the lead and invoke the legacy of Jean Monnet and the defence of half a century of European integration. It would be important to recognize the errors made in the handling of the crisis, thus to abandon austerity policies, recommend a forgiveness for the public debts that cannot be repaid and organize orderly the conversion of the Euro from *the single* to *a common* currency for the economies where internal devaluation will never restore competitiveness without leading to political and social chaos. Agreeing upon the creation of a European tax on corporate profits and capital flows, the revenue of which should be used to the reconstruction of viable productive sectors in the economies that had to abandon the Euro. This would mean that the sacrifice of the integrity of the Euro-zone could and should be associated to a consolidation of the European Union. When all members would fulfil the structural and long term conditions for adhering again to the Euro, it could be contemplated to reunite again the old continent. Nevertheless the choice of Denmark should be analysed and better understood: to keep a national currency and try to peg it to the Euro, but leave open the possibility to devalue, if necessary in exceptional circumstances defines a prudent and effective strategy. After all, were not the British right when they argued, back in the 90s, that a common currency was a better option than a Single one? Remember the choice by Swedish authorities to stay out of the Euro after a careful assessment or the pro and con (Calmfors, 1997): the ability to devalue has been quite instrumental in overcoming rather quickly major financial crisis and rebuilding a strong export sector.
- Can *citizens* organize a democratic European Spring, and start of a long process of re-embedding the economy into polity? Numerous historical episodes show that it is an uncertain process, with progress but regress as well (Tilly, 2009). For the time being, no real European agora is being constituted, whereas nationalistic parties are on the ascent and convince a growing fraction of the population that they are the real democrats, the only ones defending grass root people. Ironically, the same principle can sustain two opposite strategies in terms of national sovereignty. Either an heroic federalist movement convinces all public opinions across Europe that, given the contemporary forces that shape the world, such democratic principles can only materialise at the continental level. Or populist support continues to raise election after election, they finally attract a majority of voters and get their support for a return to the full attributes of national sovereignty. Clearly the odds are presently in favour of this second scenario.

CONCLUSION

Most current analyses of the Euro crisis adopt a mono-causal, static and finally ahistorical approach that does not capture the specificity and severity of the present situation. This article proposes an historically grounded study of the ideational, political and financial processes that lead to the opening of a major, systemic institutional crisis of European integration and not only of the Euro-zone.

1. Since its foundation period, the European integration has made institutional progress through recurrent economic and political crises, and finally the *functionalist method* proposed by Jean Monnet has proven to be quite effective. Each step forward generates expected or surprising disequilibria that call for a further deepening of cooperation at the European level. The crisis of the Euro-zone is therefore not an exception since it is an opportunity for new steps in the direction of a genuine form of federalism. Nevertheless, the crisis of a monetary integration without financial and fiscal federalism confronts the policy makers to a dilemma: “*Europeans would be as strong as if Europe was united, retain as much sovereignty as if it was not. This contradiction has become untenable.*” (Goulard and Monti, 2012). One observes *clear political barriers* to the delegation to Brussels of further sovereignty attributes to a federal entity, especially when the imposition by Brussels of austerity policy is perceived by many public opinions as socially unfair and economically inefficient.
2. It is drastically difficult to build supranational institutions in the epoch of *globalised and deregulated finance* that is permanently screening the relevance and viability of national and European economic policies. Without the related redeployment of financial portfolio among the members of the Eurozone – via the diversification of the holding treasury bonds of Southern Europe and the acquisition of foreign banks – massive real estate bubbles would not have emerged in Ireland and Spain. Similarly, governments would have been unable to finance their soaring structural public and/or external deficits. If capital market volatility could be curb down – for instance by an adequate taxation – then the European public funds recently created could restore the credibility and viability of the Euro. Unfortunately, most governments have fully *delegated the strategic choice* about the allocation of capital to private finance and nowadays they no longer know how to regain control over financiers. In a sense, the Euro is one of the main victims of the political power acquired by international finance, i.e. the unexpected outcome of internal and external deregulation promoted by governments of various ideological orientations.
3. Surprisingly enough, financial markets have been *unable to anticipate* the perverse consequences of their strategies, built upon the belief that all public finance perceived given the irrevocability of the adhesion to the Euro. This was quite contrary to the explicit clauses of the European treaties. On the other side, national governments and the European Commission have *constantly under-estimated* the nature, severity and duration of the present turmoil. Actually, the present governance of the European Union manifests its structural incoherence via the repeated exploration of a vicious circle: austerity-more unemployment-larger deficit-more austerity. The traditional visions, interest and objectives of the actors of European governance have now become *irreconcilable* and this is the main reasons for the lagging and quite imperfect responses to the crisis open in the spring 2010. The June and December 2012 European Councils and the bold statement of Mario Draghi in July 2012 about the irreversibility of the Euro open new opportunities but all the relevant European institutions are still to be implemented and monitored.

4. Actually, a positive contagion is taking place among the financial community, transitorily relieved by the move towards banking and financial federalism and a better coordination and monitoring of national budgetary policies. Given the long period between the agreement upon principles and the effective implementation of the complex architecture of national and European independent authorities, any *bad news*, however minor, may trigger a new *financial panic* because operators dislike uncertainty and tend to react by mimetic moves, since a wave of naïve optimism is frequently followed by a phase of dramatic pessimism, faraway from a balanced view of the objective risks they face. Furthermore, the *real economies unbalances* between members of the Euro persist: trade deficit in the South versus large surplus in the North, specialisation in the services versus strong competitiveness in manufacturing, gap in the quality of the management of public expenditures – the tax systems. The structural disequilibria that generated the spring 2010 Euro crisis have only partially been reduced and they persist to be a major threat upon the economic recovery of the European Union.
5. Contemporary policies face the *conjunction of challenging dilemma*. First, most governments would like a stronger Europe that could help their ailing economy but simultaneously they are reluctant to finance common European funds and they frequently want to keep a clear control of their banks and public finances: “federalism for all except for me!” seems to be their motto. Second, the succession of waves of optimism and pessimism is quite detrimental to the pursuit of a stable strategy of economic reforms and new institutions building: excess of inefficient activism in reaction to the risk of depression, naïve relief when the pressure of financial market is relaxed. Third, recurrently the progress towards a form of federalism is blocked by the dilemma between solidarity and moral hazard risks. If weak States are bailed out by healthier ones, then the governments will stop their own efforts but conversely if they are not recued, the whole European Union might collapse. Last but not least an equivalent issue affects the coordination between European monetary policy and national public spending and taxation: if the ECB is too accommodating, the spread upon the domestic treasury bonds is reduced and the required reforms are postponed; conversely a restrictive European monetary policy may trigger an economic recession that makes unsustainable domestic public finances. The synchronisation of European and national interests and the coordination across the various tools of economic policy exhibit an unprecedented complexity, a challenge both for *academic theorizing and political strategy*.
6. Consequently *systemic crises* show the impossibility in prolonging *past determinism* and strategies but simultaneously they point out the radical uncertainty that face the innovations required to overcome either a dramatic depression – analogous to the American great depression – or the repetition of vicious circles – similar to those observed for the Japanese economy since the 90s. It is thus prudent to propose a *whole range of scenarios* instead of a mere central forecast derived from econometric studies. The basic hint of this article is simple enough: the emergence of a *key collective actor* is required – let it be international finance the European Central bank, the European Commission, the European Parliament, European citizens,... - in order to progressively resynchronise and reorganise the complex and incoherent present architecture of the European Union and not only the Eurozone.
7. The European Councils of the 2012 and early 2013 have propagated the feeling that the Euro crisis is over. Private capital goes again to Southern Europe and this feeds the illusion that public interventions will prove to be unnecessary. This optimism totally neglects the fact that in most contemporary economies the evolution within finance has largely divorced from the real economy trends and fundamentals. In Europe, unemployment continues to rise and long term stagnation – a lost decade! – is more likely than a fast and resilient economic recovery.

How long will European citizens accept an economic order so detrimental to their welfare?
This might well be a sword of Damocles over the future of European integration.

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Figure 1 – Half century of European integration: building European public goods out of recurring crises

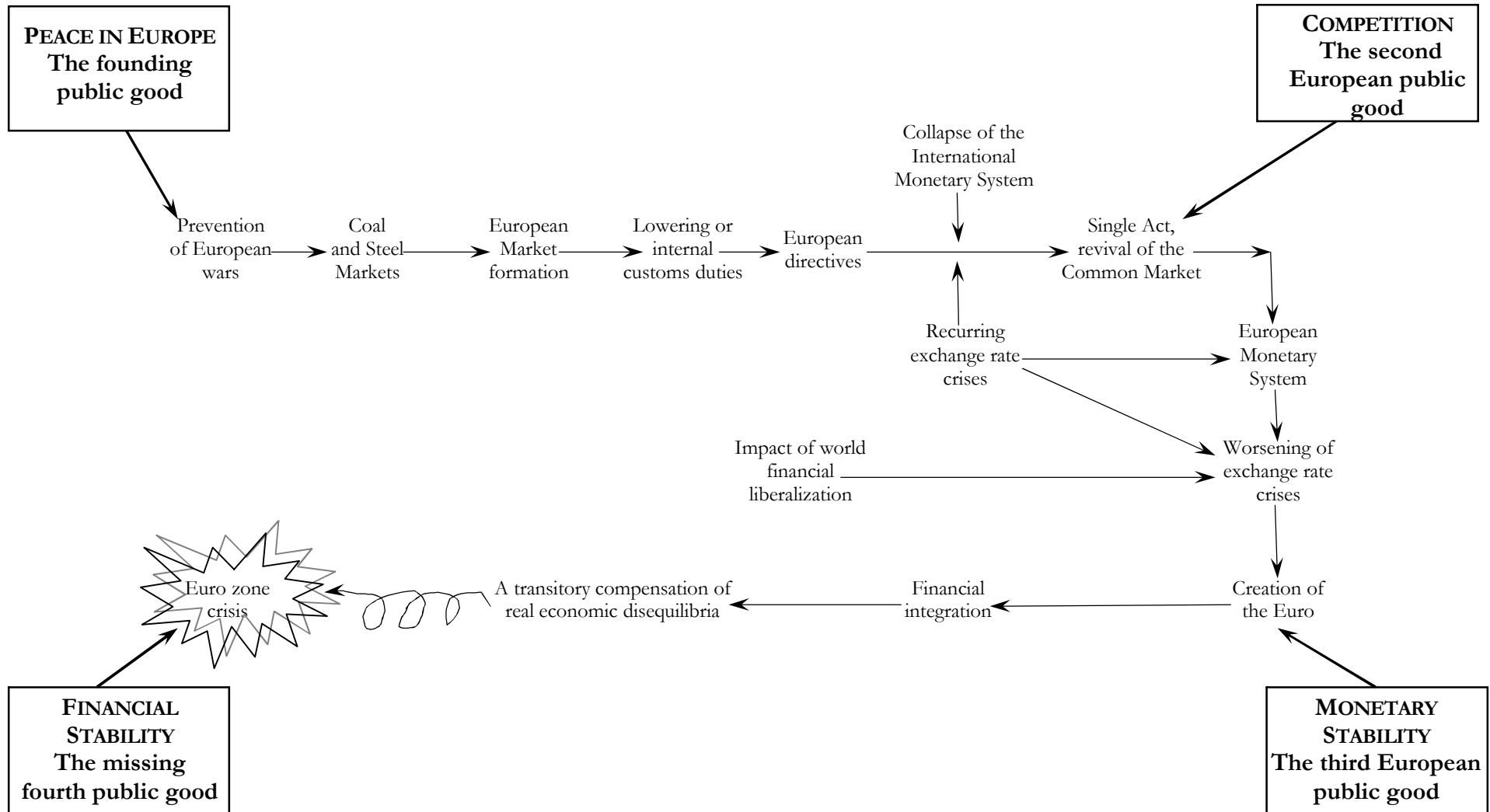
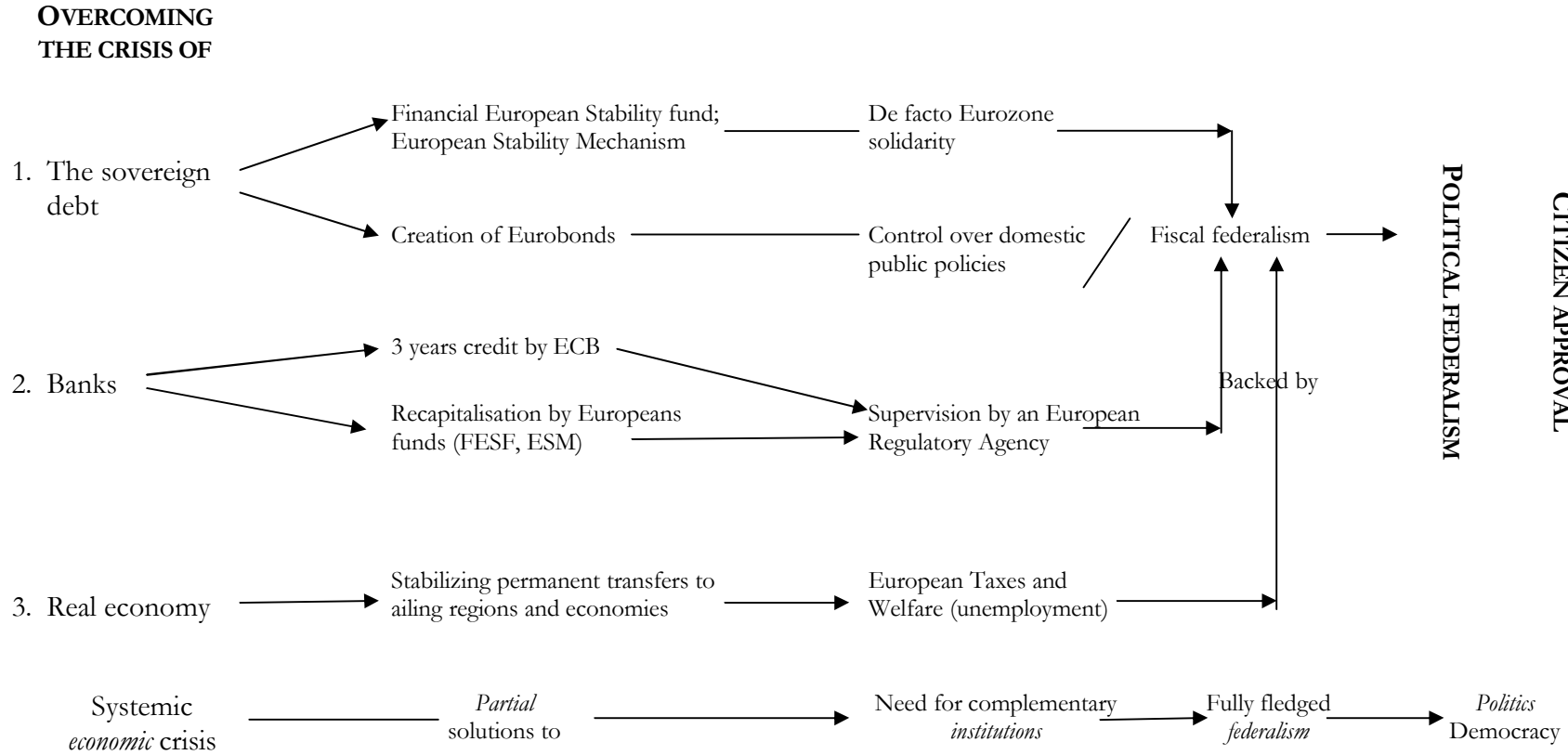
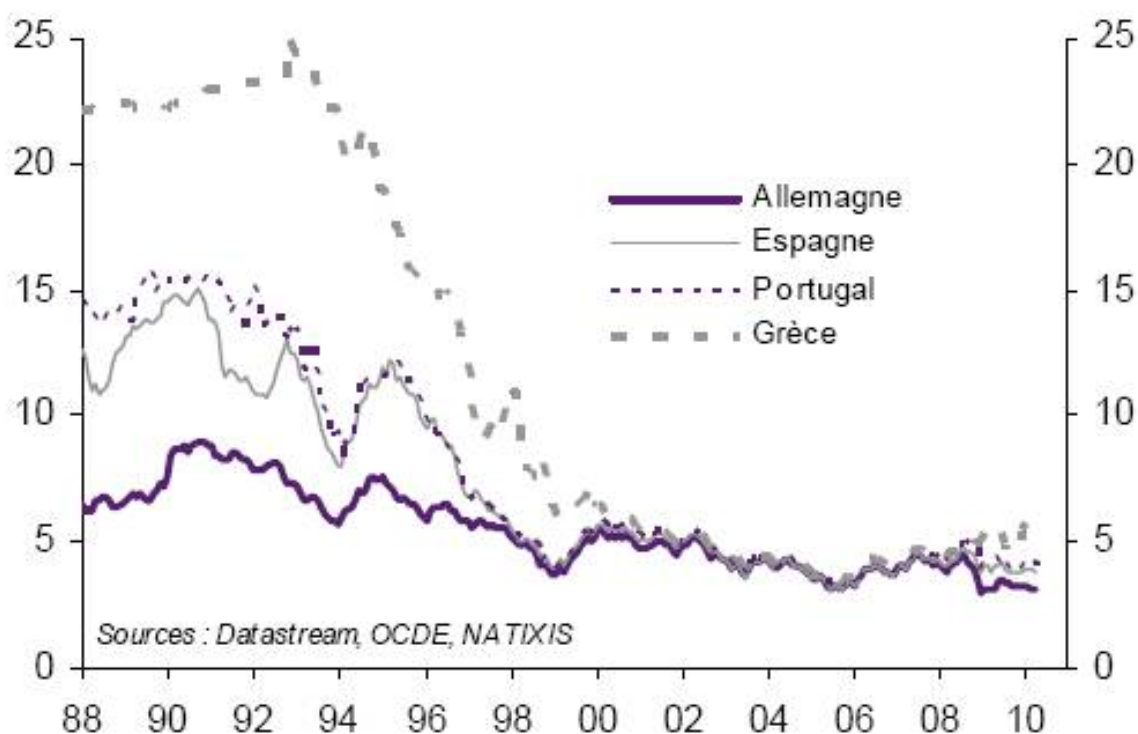


Figure 2 – An economist dream, the return to the functionalism approach to the rescue of the Euro: financial, fiscal and then political federalism



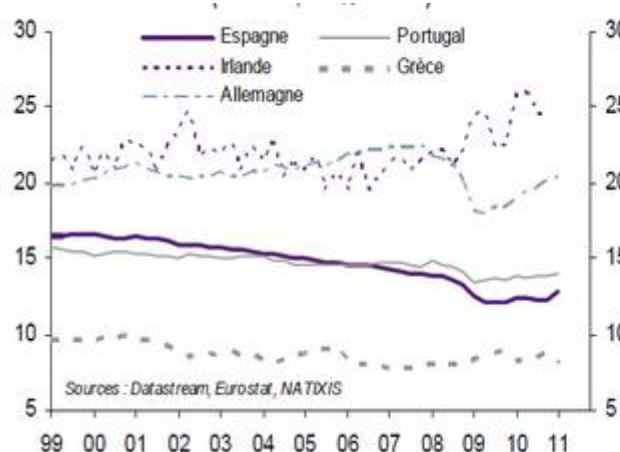
Graph 1 – A convergence of 10 years Treasury bonds interest rate



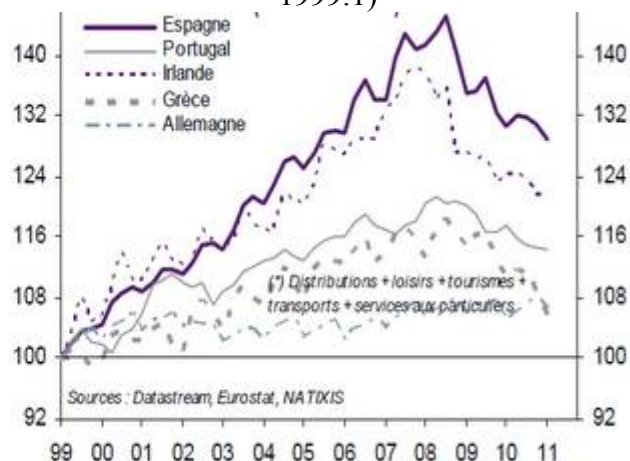
Source : Patrick Artus (2010), « Quelle perspective à long terme pour la zone euro ?, *Flash Economie*, n° 158, 12 Avril, p. 4.

Graph 2 – A deepening of intra-European specialization: manufacturing in the North, service in the South

A – Share of manufacturing in total value added



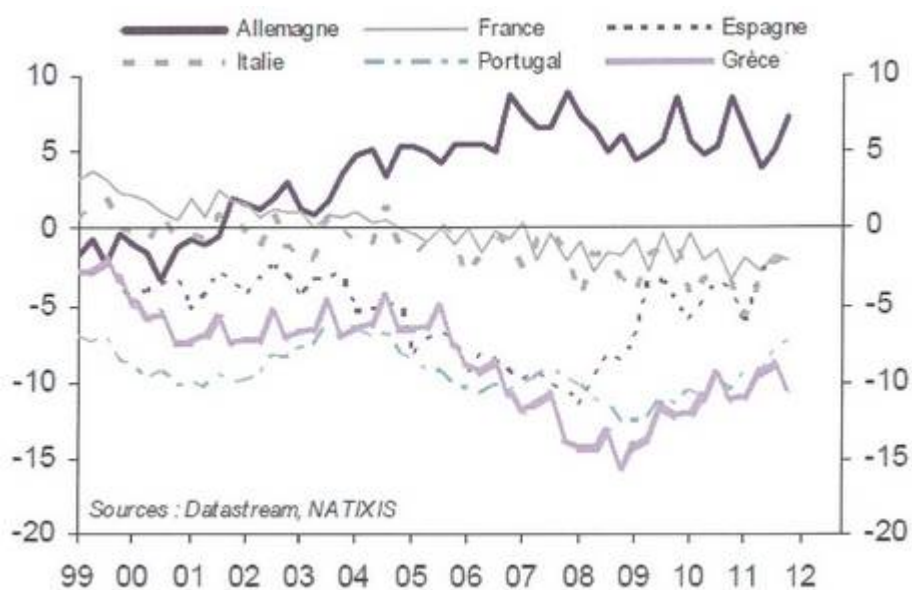
B – Employment in domestic services (100 in 1999.1)



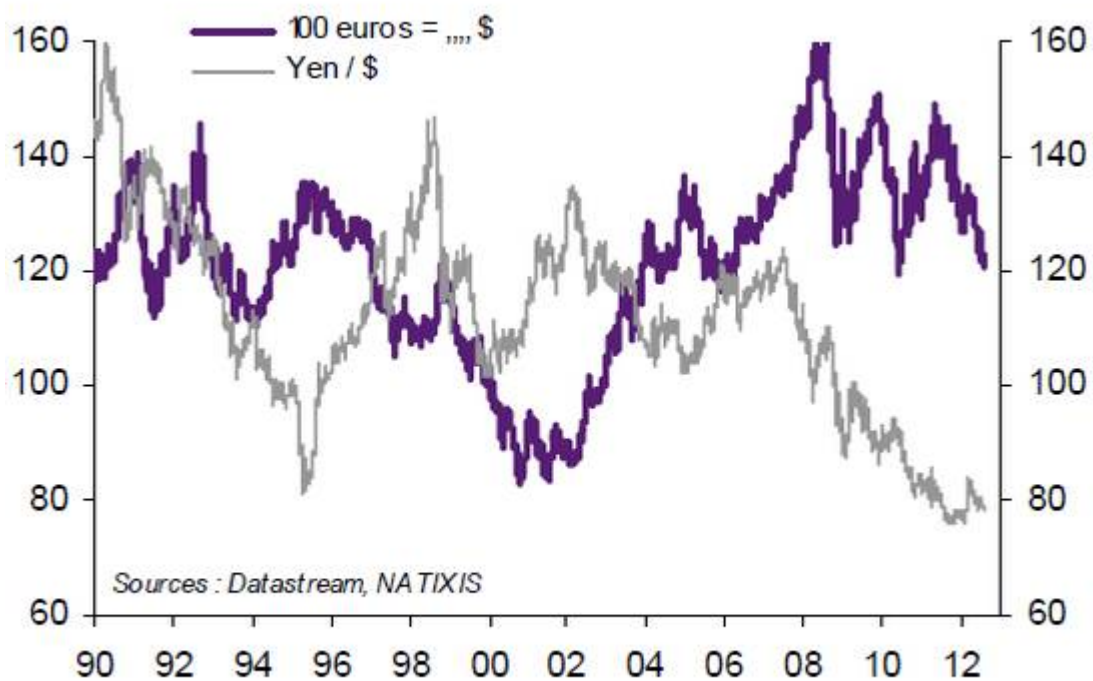
Source : Patrick Artus (2011b) « Pourquoi n'a-t-on pas vu, de 1999 à 2007, les problèmes de l'Espagne, du Portugal, de l'Irlande, de la Grèce? », *Flash Economie*, n° 534, 9 juillet, p. 5.

Graph 3 – A polarisation of external balances within the Euro zone

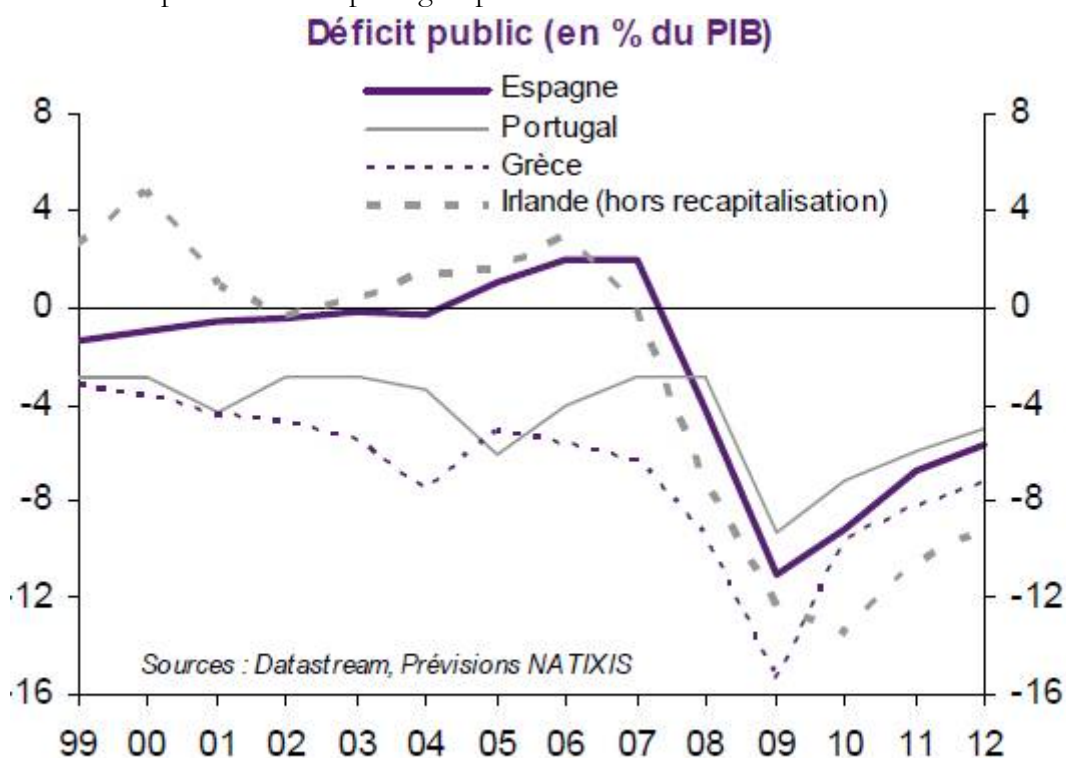
Current balance / PIB (%)

Source: Patrick Artus (2012a), *Flash Economie*, n° 347, 21 mars

Graph 4 – The evolution of Euro/dollar/yen exchange rates.

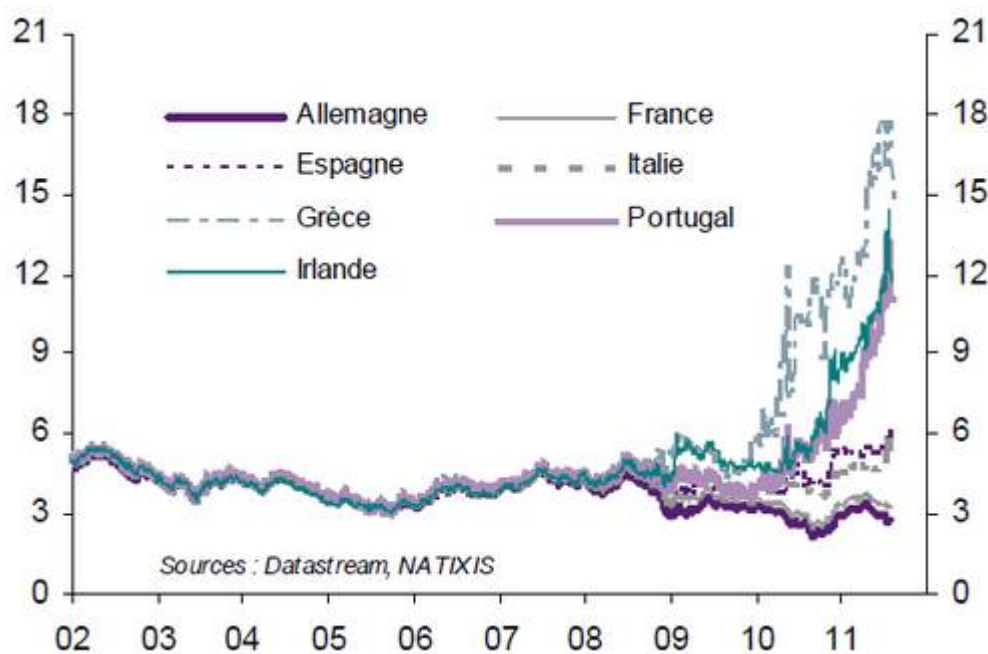
Source : Artus (2012b), *Flash marches* n°535, page 6

Graph 5 – The deepening of public deficits after 2008: selected countries.



Source : Artus Patrick (2011a), L'introduction du fédéralisme dans la zone euro : les avantages et les risques, *Flash économie*, 18 avril 2011, numéro 284, p. 7

Graph 6 – The brutal explosion of the cost of refinancing of public debt of Southern Europe economies



Source: Artus Patrick (2011c), “La crise de la zone euro nous apprend beaucoup sur le fonctionnement des Unions Monétaires ; l’euro est-il sauvé?”, *Flash Economie*, n° 599, 9 août, p. 5

Figure 3 – Disentangling the various causes of the Euro zone crisis

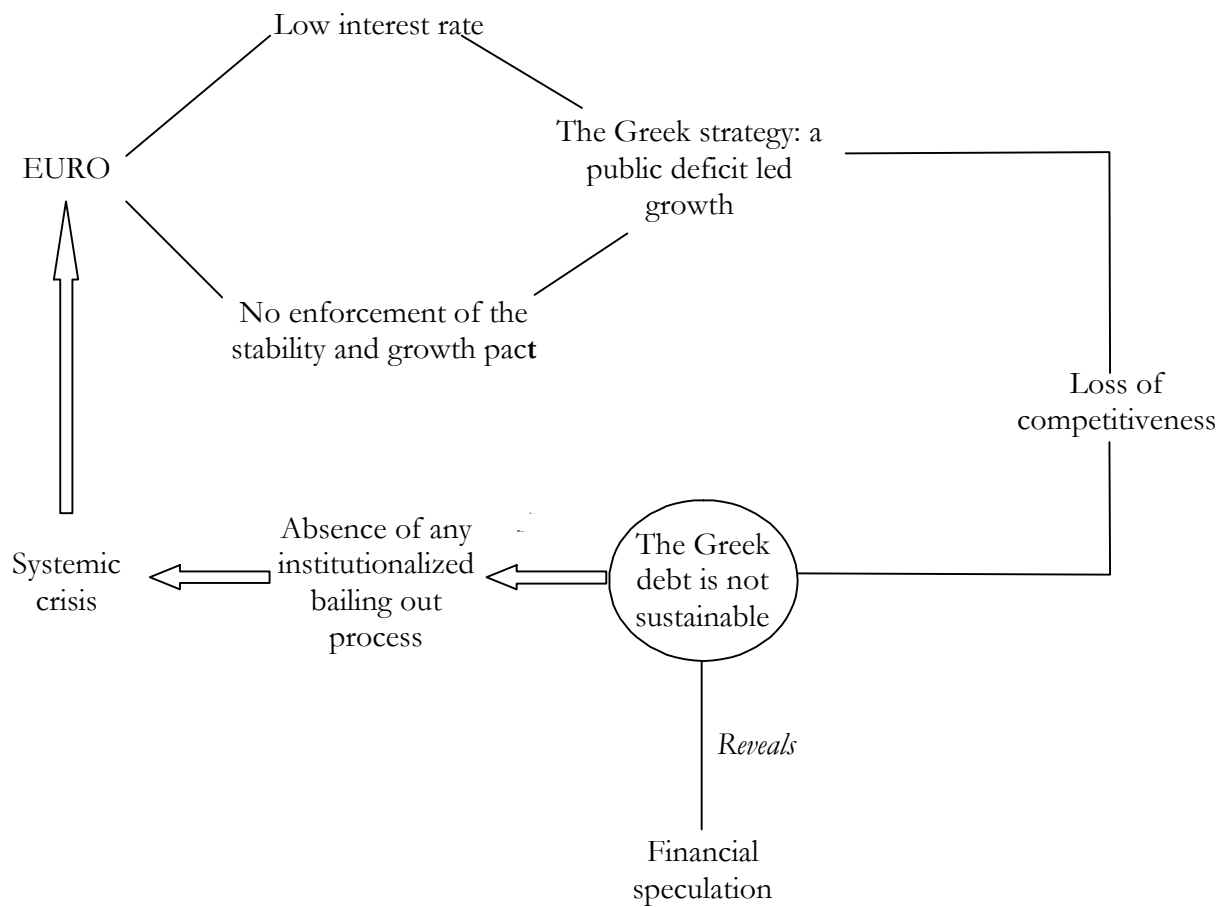


Figure 4 – The unfolding of the Euro crisis: a progressive resonance between all financial institutions

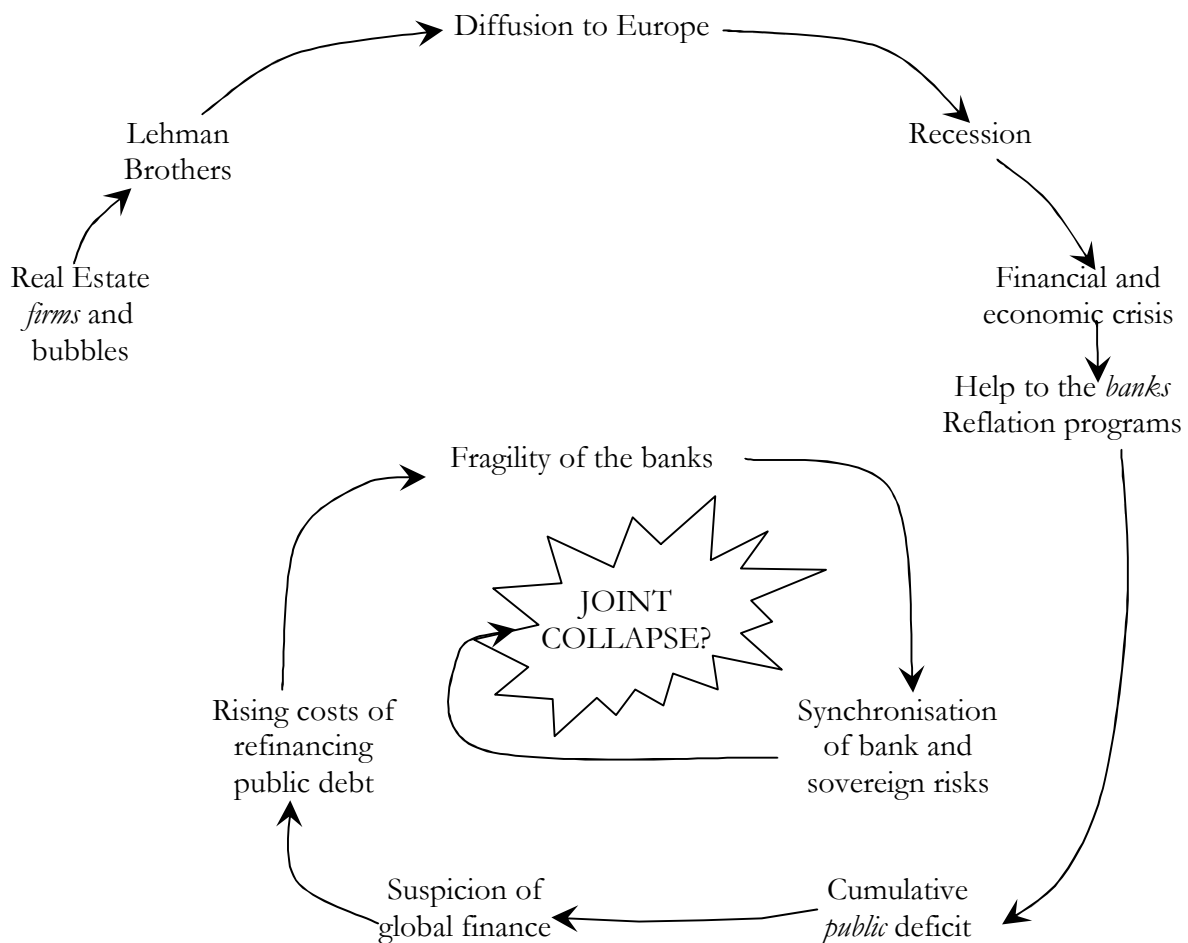


Figure 5 – Announcing steps toward a more coherent Euro-zone may hinder the way out of the present crisis

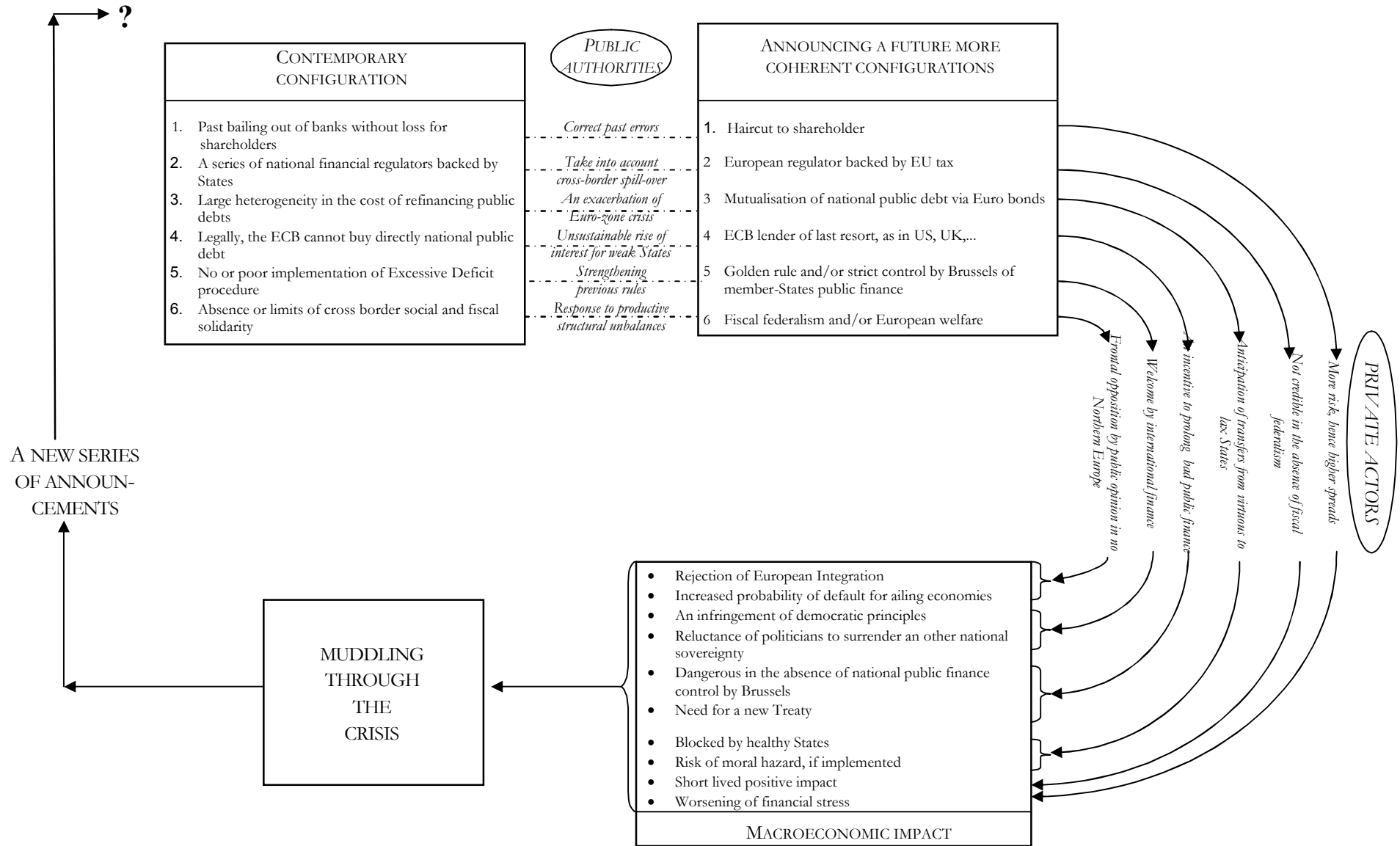


Figure 6 – The muddling through in the Euro-zone: the consequence of the conflict between the objectives and interests of a web of actors

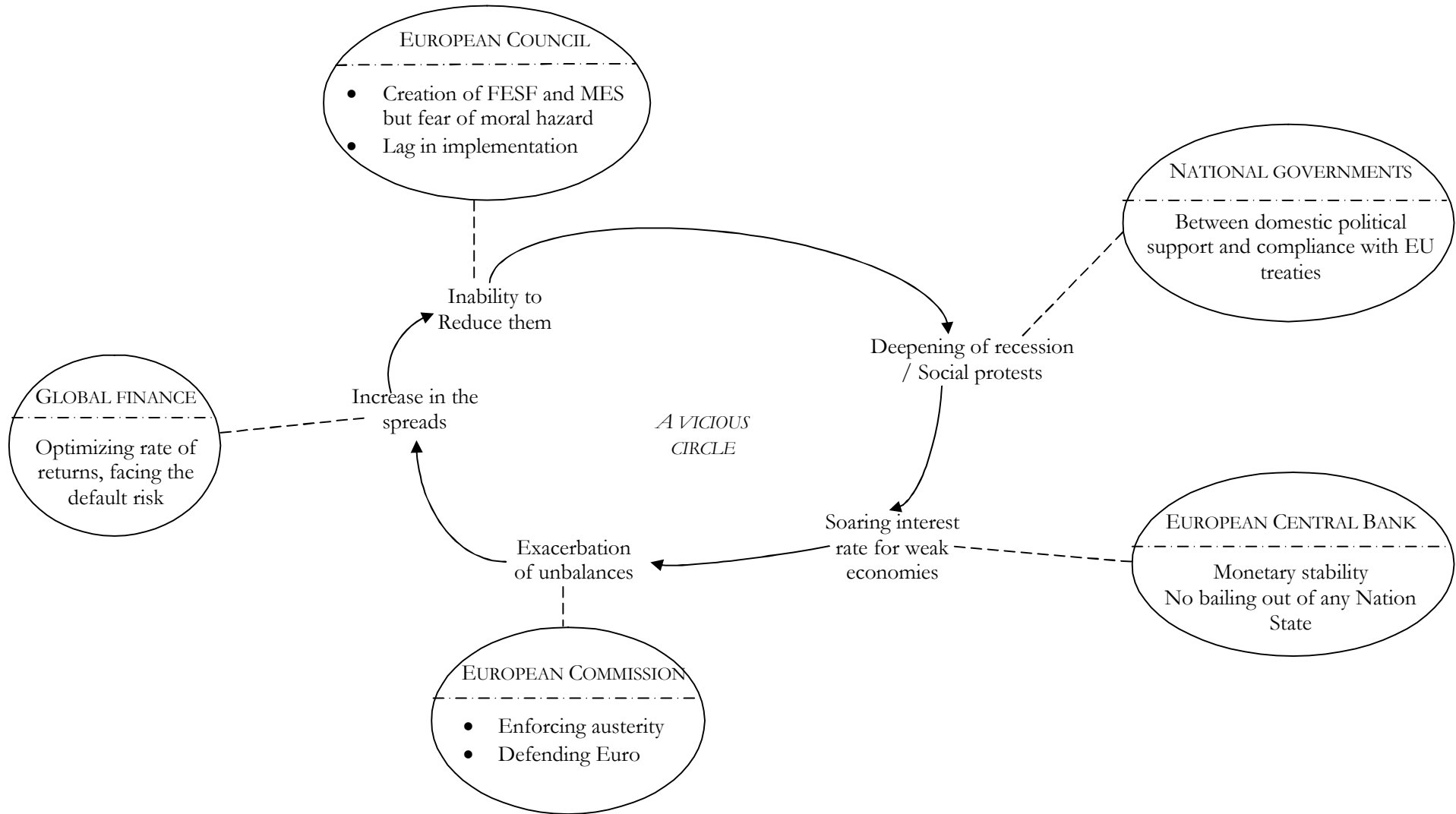


Figure 7– The North / South divide is an obstacle to the building of new federalist institutions

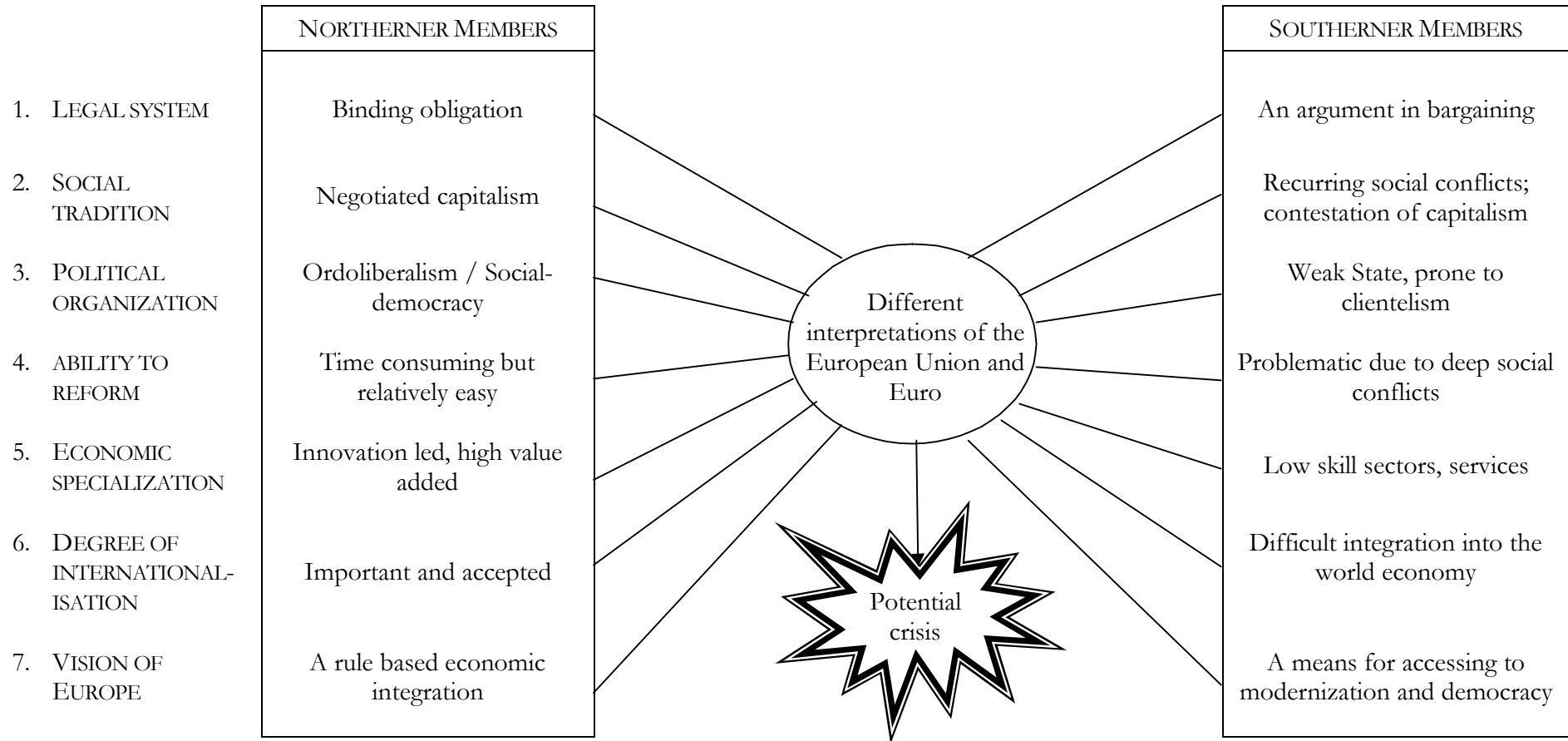


Table 2 – The various reform proposals since the Greek sovereign debt crisis

	IMPACT	PRINCIPLE	ECONOMIC EFFICACY / EFFICIENCY	POLITICAL FEASIBILITY
NATURE OF REFORMS				
1. Controlling opportunism of finance: • Interdiction of short-selling • Taxing capital movements • Separating commercial and investment banks		Reduce the gap between fundamental value and market price	Possible but no impact on European governance.	Unequal according industrial or financial specialization
2. European public rating agency		Fight against the three private agencies bias	Moderate but not central for the EU	Interesting for governments , problematic acceptance by for private players
3. European agency in charge of public finance assessment and control		Name and shame failing governments	Problematic because still less coercive power than that of SGP	Poor because lack of legitimacy by citizens
4. Creation of a European financial rescue fund EFSP, ESM		Equivalent of the IMF for the EU, in charge of rescuing failed states or banks	Limited if domino effects to large economies Difficult practical implementation Moral hazard problems	Blocking or resistance of healthier economies
5. Constitutional limits on national public finance: Golden rule with automatic sanctions		Make impossible a public finance lax leading to a systemic crisis	Possible during prosperity Difficult within a major crisis Adverse impact of related austerity	Inability to comply if deep recession/stagnation Risk of fracture between North and South easy / Difficult compliance
6. From loose governance to an explicit economic government of the Euro-zone with explicit growth strategy		Complete overhaul of the European policy mix and construction of a viable one	Better than in the current Treaties, provided that the coordination costs are not too high	Most public opinions against another transfer of sovereignty to the Euro-zone
7. Emission of Euro bonds as the starting point for fiscal federalism		Mutualisation of financial risk Lower interest rate	Risk of moral hazard if no control over national public policies Problematic in the eye of a systemic crisis	Implies fiscal federalism Possible way out of future crises after several decades of federalist moves: France versus Germany

Table 3 – Solving the incompatibility of objectives and interests by the leadership of a key-actor

KEY ACTOR	STRATEGIC ASSET	IMPACT ON EURO	FINAL CONFIGURATION	PERMISSIVE FACTORS	BLOCKING FACTORS
1. INTERNATIONAL FINANCE SETS THE DESTINY OF THE EURO	Mobility and volume of assets controlled	Speculation reveals the inability of reforming the Euro	Breaking of the Euro 1. Exclusion of insolvent States 2. A two speed/tier Euro with flexible exchange rate 3. Abandon of the idea of a single currency, return to complete national sovereignty	<ul style="list-style-type: none"> • Impotence of European authorities • Conflicting national interests 	<ul style="list-style-type: none"> • Loss of legitimacy of high finance after recurring scandals • Coordination of major central banks to restore financial stability
2. THE EUROPEAN CENTRAL BANK FIGHTS BACK	Monetisation of public debt; Lender of last resort for banks	<ul style="list-style-type: none"> • Mitigates speculation • Gives time to other actors in order to adjust their objectives and correct structural unbalances 	Pragmatism but coherence <ul style="list-style-type: none"> • Debt forgiveness for insolvent States • Rescheduling for illiquid States • Fiscal federalism in order to rebuild the competitiveness of weak economies 	<ul style="list-style-type: none"> • Compromise between the German and Keynesian conceptions of Central banking • Knock down impact upon European Commission and European Council 	<ul style="list-style-type: none"> • Opportunist behaviour of national governments • Irreconcilable conceptions of central banking • Impotence of weak States
3. THE EUROPEAN COMMISSION: A NEW COMMUNITY APPROACH REVIVAL	Defence of European public goods, including the Euro, by a strong European Commission	Complete re-foundation of EU, making viable the Euro as a common by not single currency	An European Community <ul style="list-style-type: none"> • Euro as federal currency, along with national moneys • Taxation of capital at the EU level • An European financial regulatory and federal deposit insurance • A stabilization funds to reindustrialize the weakest economies 	<ul style="list-style-type: none"> • Recognition of large productive heterogeneity • Devaluation far better than inefficient austerity policies • The principle of solidarity better fulfilled by growing economies 	<ul style="list-style-type: none"> • The pride of not admitting the flaws in the design of the Euro • Loss of expertise and leadership of European Commission • Past primacy of intergovernmental negotiations at the European Council
4. EUROPEAN CITIZENS TAKE THE POWER	The democratic principle: control people of the political and economic institutions they live with	Uncertain according to the level of action: either typically national or European	OPPOSED OUTCOMES Economic nationalism Democracy can only be expressed at the level of the Nation-State Re-capture of full sovereignty, including monetary one Democratically negotiated Europe Radical political innovations allow a democratic EU	<ul style="list-style-type: none"> • The collapse of austerity policy both inefficient and unfair • Diffusion of grass roots movements against undemocratic reforms 	<ul style="list-style-type: none"> • Some nostalgia for golden past • Democracy or typical nationalism? • Danger and limits of protectionism • Europe is not yet constituted as a democratic arena • Opposed conceptions within the same parties (left or right) • Domination of powerful lobbies defending statu quo • Reluctance of new social movement to organize themselves as national / European political parties