Introduction

The European debt crisis started as a small local policy shock in Greece, but it has come to threaten the survival of the Euro and ultimately of the whole European project. Finding the proper policy responses is therefore crucial.

Yet without correct theoretical analysis, practical measures to overcome the euro crisis may fail or even make the crisis worse. This is what we have seen over recent years. The dominant policy consensus, which was strongly shaped by German policy makers and then gradually adapted by the European Commission and most member states, claims that the crisis is a consequence of excessive deficits and violations of the Stability and Growth Pact. This consensus sees the reasons for the lack of budget discipline either as political irresponsibility or as the desire to cover up for losses in economic competitiveness. The logical policy response is, therefore, on the one hand a tightening of the fiscal framework, and on the other hand structural reforms to restore competitiveness.

This policy consensus explains certain aspects of Europe's economic difficulties, but it ignores some important features of the crisis. First of all, there is a problem with timing. Structural reforms take a long time to implement and even longer to produce results. They are therefore unlikely to address the immediate crisis. Secondly, the consensual view articulates competitiveness within the Euro Area primarily in terms of current account imbalances and not in terms of relative prices and costs. However, as we will argue below, balance-of-payment flows in monetary union cannot be reduced to competitive advantages. Thirdly, tight budget discipline is needed in a boom, but in the recession it will aggravate the crisis and push up unemployment. Hence, fiscal austerity has short-term effects that could prevent the long-term objective from ever being reached. There is evidence that this is precisely what is happening in

Greece (Collignon 2012). Fourthly, the dominant policy consensus ignores the impact made by the financial crisis of 2008 on banks' balance sheets and the liquidity in Europe's imperfectly integrated financial markets. Policy makers have, therefore, often refused to bail out debtors in distress and failed to calm markets. Given these shortcomings, a broader view of analysing the crisis is needed.

There are two theoretical models for explaining the European debt crisis.[1] The fundamentalist interpretation focuses primarily on imbalances in macroeconomic *fundamentals*, such as budget deficits and current account imbalances between member states. It recommends sticking to the principles of 'a sound and competitive macroeconomic base and solid public finance' (Weidmann 2001). The remedy is, therefore, to implement 'painful reforms' and consolidate budgets, which would rebuild trust and confidence in financial markets (Issing 2009). The Commission (2010) has also argued that large macroeconomic imbalances have made the finances of EU and Euro Area member states more vulnerable to economic shocks, and it has therefore suggested that fiscal policy should not be viewed in isolation. In order to address this issue, the European Union has created the new *Excessive Imbalance Procedure*, which is to serve as a tool for surveillance and correction of unsustainable imbalances and persistent distortions in competitiveness.

Alternatively, *monetarists* explain the European debt crisis as a liquidity crisis. Their argument goes as follows: a small local liquidity shock causes a sudden deterioration in a specific class of asset values. For example the Lehman bankruptcy represented such a shock which caused many asset prices to collapse; it was followed by a second shock when the newly elected Papandreou government revealed that its predecessor had lied over budget deficits and, as a consequence, the value of Greek government bonds fell rapidly. These shocks placed the banks' balance sheets in difficulties and reduced their equity.[2] When banks started to distrust each other's creditworthiness, their need to hold highly liquid assets spilled over into the financial system as a whole. Financial institutions and investors then responded by selling less liquid assets and this

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1. These two views resemble the debate between *economists* (mainly in Germany) and *monetarists* (mainly in France) in the 1980s

2. Write-offs of losses for banks after the Global financial crisis have amounted to 10-20 percent of banks' net worth. See Collignon 2011b reinforced the collapse of asset prices. At that point a full-blown systemic financial crisis becomes inevitable. Banks will now restrict their lending and the ensuing credit crunch will turn the financial crisis into an economic crisis that will affect the entire 'real' economy. The resulting output and revenue losses will increase budget deficits and public debt ratios, thereby further undermining trust and confidence in the economic situation (Chacko et al. 2011; Collignon et al. 2011). In this case, a crisis must be stopped by a lender of last resort who restores trust and confidence and ensures that markets remain liquid. Only a lender of last resort can provide the liquidity necessary to prevent the crisis from turning into a default avalanche. Thus, although the views of fundamentalists and monetarists are not mutually exclusive, they have very different implications for policy.

This paper is an attempt to bridge the gap between monetarists and fundamentalists. Unless the short-term problems of Europe's financial crisis are dealt with immediately, the time required to overcome Europe's structural weaknesses may run out. We therefore need to articulate a strategy that will assure markets' access to liquidity, while the consolidation of public finances and the elimination of competitiveness gaps will be achieved only gradually. However, building bridges requires an open mind and new thinking. Though policy makers claim to have learned from past mistakes, they stick too often to old ideas. This is due not only to diverging interests, such as the need to protect national tax payers, and so on, but also to the application of inappropriate economic theories in the context of European integration.

Ultimately, Europe's policy problems result from a conflict between political correctness and economic logic. Political orthodoxy maintains that member states are sovereign, while from an economic point of view they are provinces in Euroland. Governments believe that they can ignore the external effects that their policies exert on all others, while welfare optimization requires that, in an integrated market with a single currency, these externalities be regulated in the common interest. This inconsistency has, no doubt, deepened the Euro-crisis. Despite governments' attempts to muddle through, this conflict between old political thinking and new economic requirements will not be solved until either the EU has been dismantled and every state returned to the nation state logic, or a fully integrated and democratically controlled macroeconomic policy framework has been set up. *Tertium non datur*.

In this paper, I take it for granted that the arguments in favour of European integration are far more convincing than those calling for a return to *Kleinstaatlerei*. However, I will argue that, despite their best intentions, European authorities have implemented reforms that remain stuck in old thinking and unlikely to solve Europe's crisis. The reason is a misperception of how monetary union works. In the first part of this paper I will critically discuss the policies, institutions and mechanisms of monetary union, as well as the nature of macroeconomic imbalances in the Euro Area. In the second part, we will move on to focus on cost competitiveness in the Euro Area as the more relevant concept for explaining and correcting imbalances. In the conclusion we will look at possible developments for the future.