Introduction

In mid-2003, a High Level Group convened by the then-President of the European Commission (EC), Romano Prodi, published a report entitled 'Agenda for a Growing Europe'. The report praised the advancements of Europe's economic integration in its various policies, from the Economic and Monetary Union to the internal market and the commercial (international trade) policy. As it highlighted, 'judged by the progress made in the integration process, there is no doubt that the period of the last 15 years has been a tremendous success'.[1]

Simultaneously, the Convention on the Future of Europe was presenting its draft Treaty Establishing a Constitution for Europe. A year earlier, twelve out of the then fifteen EU Member States started to use coins and banknotes bearing European symbols. Economic convergence between the poorer and the richer Member States seemed to be advancing. The Lisbon Agenda, launched in 2000, promised to make the EU 'the most competitive and dynamic knowledge-based economy in the world' by 2010.[2] The 'Big-Bang' enlargement of 2004 would happen in less than a year, elevating the European project to an entirely new level. Romania and Bulgaria were waiting next in the accession pipeline.

All of these unprecedented events appeared to corroborate that Europe's political processes were profoundly robust. The way the 1999 Santer Commission debacle was resolved implied that the EU's

[1] André Sapir et al., 'An Agenda for a Growing Europe. Making the EU Economic System Deliver', July 2003, 1, available at cejm.univ-rennes.eu/digitalAssets/24/24407_sapirreport.pdf.

[2] Lisbon European Council 23 and 24 March 2000 Presidency Conclusions, Sec. A.5., available at www.europarl.europa.eu/summits/lis1_en.htm.

governance system was adaptive and open to improvements,[3] while the simultaneous German economic reforms under the Schröder government suggested that ailing Member States were capable of overcoming on their own the economic crises they were encountering. Only the most obdurate naysayers could fail to appreciate both the speed with which the continent was being united and the soundness of the foundations on which the unification process was based.

Then, however, the foundations started cracking. The Constitution for Europe was foiled in the French and Dutch referenda. The attempts to push the limits of the internal market in the fast-growing service sector with the Bolkestein directive petered out soon after.[4] The sovereign debt crisis revealed the excessively optimistic assumptions behind the Economic and Monetary Union. Unemployment skyrocketed in some European countries and receded to very low levels in others. European policies, previously hailed for paving the way to economic convergence, suddenly either amplified the instability or became patently ineffective in mitigating it. From a breathtaking phenomenon a decade earlier, the economic integration became a serious headache for policymakers at various levels of the European governance system. The ideology of the economic integration driving it since the mid-1980s was unravelling fast.

Some could see it as part of a bigger plan. After all, it was Jean Monnet, one of European integration's founding fathers, who claimed that 'Europe will be forged in crises, and will be the sum of the solutions adopted for those crises'.[5] According to a cognate neo-functionalist perspective,[6] incomplete initial political and economic choices should not be particularly disturbing. In fact they could be conceived of as the main driver of the European project, because successors of those who create incomplete or incompatible policies would be forced to push the integration further, rectifying the flaws once the original incompleteness turns its head.

[3] More broadly on the related developments, see Christian Joerges, Renaud Dehousse, eds, *Good Governance in Europe's Integrated Market* (Oxford: Oxford University Press, 2002).

[4] Proposal for a Directive of the European Parliament and of the Council on Services in the Internal Market, COM(2004)2.

[5] Jean Monnet, *Mémoires* (Paris: Fayard 1976): 488.

[6] For a concise yet rich introduction to the concept, see esp. Carsten Strøby Jensen, 'Neofunctionalism', in: *European Union Politics*, eds. Michelle Cini and Nieves Pérez-Solórzano Borragán (Oxford: Oxford University Press, 2016): 53–64.

The recent economic recovery throughout the EU, largely engineered by bold actions of the European Central Bank (ECB), could seem to corroborate this very point. In the last full year before this book went to press (2016) the EU's real gross domestic product (GDP) growth outperformed the USA's (1.9 per cent against 1.6 per cent).[7] Unemployment in the Eurozone is diminishing. Market confidence largely returned.

This book will argue, however, that the recent economic recovery in the EU (and in the Eurozone in particular) does not stem from any serious improvements in the foundations on which the economic prosperity relies. Persistently low inflation allowed the central banks of the Eurozone to monetise a pile of public debt and to replace it with a pile of central bank money, injected into the banking system without deteriorating the value of the euro. As far as the effects of this alchemic transmutation last, neo-functionalists can maintain the prescience of their theory.

Their perspective misses an important point, though: in peaceful times persistently high public debts are caused by malfunctioning public policies and institutions. It is easy to forget about this relationship when one more – and very big – compartment for stacking up the public debt has been found. But this feat does not make the public policies and institutions responsible for the debt any sounder. All it does is to treat the symptoms of an ailment without addressing its real causes.

In other words, and contrary to the sanguine view prevailing as this book goes to press, the way the Eurozone crisis has been overcome largely corroborates a much less optimistic point: when encountering policy failures caused by their predecessors' mistakes, economic policymakers have largely been entrapped by time-inconsistent incentives. They are tempted to prioritise temporary solutions producing short-term gains at minimum short-term cost, even if in the longer perspective the relationship between the costs and the benefits of the same policy choices is quite certain to reverse. These time inconsistencies are clearly discernible both in the original design of major European economic policies and in responses to their subsequent crises. While scholars can gnash their teeth at it, the time-inconsistent character of the contemporary policymaking (not only at the EU level) is hard to resist for elected politicians, whose thinking is naturally dominated by voting calculations scarcely ever transcending the next

[7] Organisation for Economic Cooperation and Development (OECD) data for the USA, Eurostat data for the EU 28.

elections. When confronted with a policy failure, they are under very serious pressure to extend and pretend, unless fixing the failed policy entails no serious political costs. The ex–Prime Minister of Finland, Alexander Stubb, made the same point when he opined that 'the EU is constant crisis management. You move from one crisis to the other and, at the end of the day, it's just a question of the size of the crisis and who gets hit the hardest. I have always believed the EU advances in three-phases: Phase no. 1 is crisis, phase no. 2 is chaos and phase no. 3 is sub-optimal solution, and that's very much the nature of the beast.'[8]

The sub-optimality may easily be judged as fair enough when economies grow and unemployment decreases. But, instead of inducing policymakers to rebuild the many precarious linchpins sustaining European economic integration, it has lulled them into what Robert Feldman once described (in the context of the ultimately quite similar Japanese economic travails) as the CRIC cycle: crisis, response, improvement and complacency.[9]

The time-inconsistent nature of the responses to side-effects of the major European economic policies can be attributed not only to policymakers' time-inconsistent incentives, but also to the fact that a policy flaw is often relative. A certain socioeconomic choice at the European level may provoke a crisis in one society, while making other societies wealthier and more stable. Solidarity is extremely difficult to achieve in such a setup, as those on the upside of this distributional process can easily find ample pretexts to avoid policy adjustments. One particularly popular and salient excuse has to do with the EU's constitutional system. According to it, because the way the EU exercises its powers is defined by the Treaties,[10] substantial alterations to European policies require Treaty changes. In their turn, more moderate alterations can easily end up in half-baked policy reforms, considering that European decision-making is extremely convoluted and bristled with veto points at each level.

8 Quoted in David M. Herszenhorn, 'Alexander Stubb: Europe's Endangered Liberal Future', *Politico*, 26 December 2016, available at www.politico.eu/article/alexander-stubb-europes-endangered-liberal-future-populism-finnish-party/.

9 Robert Feldman, 'Cobwebs and CRICs', *Morgan Stanley Dean Witter's Japan Economics*, 4 April 2001, 1–4, available at www.yumpu.com/en/document/view/4429905/cobwebs-and-crics-japan-economics.

10 The Treaty on European Union (TEU) and the Treaty on the Functioning of the European Union (TFEU), subsequently referred to as 'the Treaties' or 'the Treaty'.

Most importantly of all, profound policy shifts are hardly conceivable without deep alterations in underlying worldviews, values, beliefs and ideological paradigms. Advancements in European economic integration since the mid-1980s have stemmed from some very powerful and broadly espoused beliefs. One was that the economic integration should be founded on the internal market first and foremost and that its freedoms inevitably induce an efficiency-enhancing win-win situation for all EU societies. Another is that the same applies to international trade. It has also been paradigmatic that the way the EU redistributes its resources must be extremely path-dependent. And last but not least, the Eurozone has been construed as an irreversible political process driven by capital flows and a certain attitude towards the role of markets and governments.

These beliefs, as I will argue throughout this book, are all quite intuitive and plausible. And yet, they have been responsible for various economic crises and political vortex effects driving various subsurface processes of creeping economic disintegration.

Entrapped by the time-inconsistent incentives and confronted with visibly collapsing paradigms on which the European economic integration was founded, policymakers have tended to deploy denial tactics justifying their extend-and-pretend actions. This strategy has so far been good enough to keep the Eurozone and other main linchpins of the economic integration whole. Yet, it has been engraining among many European societies the feeling that the EU is unable to come up with viable solutions to the collective problems and challenges Europe faces. This feeling was easily discernible in the UK before the Brexit referendum. It has also been confirmed by more recent opinion polls. In a survey conducted in mid-2017 by Pew Research, majorities of Greeks (86 per cent), Italians (65 per cent), French (63 per cent) and Spanish (52 per cent) disapproved of the way the EU was dealing with economic issues.[11] Even in the country spared by economic hardships in recent years – Sweden – respondents were dubious about the EU's economic policies.[12] Of the societies surveyed then, the Dutch, Hungarians,

[11] Approving minorities in these five countries were 11 per cent in Greece, 24 per cent in Italy, 35 per cent in France, 38 per cent in Spain; see Bruce Stokes, Richard Wike and Dorothy Manevich, 'Post-Brexit, Europeans More Favorable Toward EU', Pew Research, 15 June 2017, 10, available at assets.pewresearch.org/wp-content/uploads/sites/2/2017/06/06160636/Pew-Research-Center-EU-Brexit-Report-UPDATED-June-15-2017.pdf.

[12] Forty-six per cent disapprove – 42 per cent approve: ibid.

Germans and Poles perceived the EU as properly dealing with economics.[13] Perplexingly enough, however, in two of the four countries openly xenophobic parties with cynical approaches to European integration and with authoritarian proclivities are in power. And the prosperity of Germany as well as the Netherlands is partly enabled by significant economic imbalances in the Eurozone, to which the economic models of the two countries contribute.

While, therefore, political constraints may explain why clandestine tinkering with European economic policies have prevailed whenever the policies needed proper overhauls, this political tactic has produced a profoundly paradoxical situation, in which Europhiles are either unable to come up with viable reforms to failing policy paradigms, or they are unwilling to admit failures of European policies in the first place. They perpetuate schematic thinking, ignoring Einstein's famous insight that one cannot solve problems by using the same kind of thinking used when creating them. Even if the Eurosceptic thinking is self-defeating, as it builds on a craving for disconnection in an ever more interconnected world, it is alluring to many who sense that the paradigms on which European integration was based have failed and that mainstream politicians do not remedy the flaws properly. Unless those to whom European integration is dear wake up to this reality, European integration will be extremely prone to crises that at some point may tear Europe apart politically and economically.

A comfortable majority of Europeans in the EU 27 currently prefers to stay together. Yet, in some countries afflicted by the various negative economic and political processes described in this book the support for leaving the EU has swelled. In mid-2017, one in three Greeks and Italians wanted their country to leave the EU.[14] European institutions and governments of the countries on the upside of the distributional effects propelled by European integration may hope they would be able to stifle Eurosceptic movements there. In Italy in particular – the country disadvantaged both by its dysfunctional domestic politics and by European policies playing out unfavourably – a Eurosceptic government could have its arm twisted, as Syriza was in Greece back in

[13] The Netherlands: 38 per cent disapprove – 54 per cent approve; Hungary: 36 per cent disapprove – 47 per cent approve; Germany: 28 per cent disapprove – 61 per cent approve; Poland: 25 per cent disapprove – 28 per cent approve: ibid.

[14] Bruce Stokes, Richard Wike and Dorothy Manevich, 'Post-Brexit, Europeans More Favorable Toward EU', 4.

2015. But this will not make the Italian society more prosperous, nor the European integration any more stable.

As I will argue throughout this book, to strengthen the economic integration the flaws in the current paradigms behind European policies must be understood first and a convincing narrative on how to remedy them ought to follow in the second step. Both should confront the prevailing intellectual habits, beliefs and ideological oversimplifications head-on, at the same time discerning viable arguments on the left and on the right, in the Europhile and the Eurosceptic camps. Unless the understanding and the narrative stem from an accurate perception of how law, economics and politics interact in the European setup, the European project will remain fragile and contestable, while European leaders fiddle with ambiguous reports on whether there should be more Europe or less of it, more discipline or less discipline, whether a new institution should be added or not, whether a multi-speed Europe is a good thing or bad, or what 'Social Europe' actually means.

Entrapped by time-inconsistent incentives, by distributional effects amplifying conflicts, by the institutional minefield and by their intellectual habits, politicians can hardly be expected to develop this understanding and this narrative on their own. Unfortunately this is not what most scholars specialising in European integration have traditionally excelled in either. For decades, when policymakers seemed to be leading Europeans to an ever brighter future, academics could satisfy themselves with debating causes of this historically unprecedented miracle. They could compare it with developments in other places and in other times. They could develop abstract theories, or simply systematise the growing *acquis communautaire*.

Now, however, none of this is either sufficient or adequate to buttress the integration process. The decades of research on the nature of integration may only serve historians, unless scholars do their part in reassessing the paradigms of European integration, unless they follow Einstein's precept and unless they develop convincing narratives justifying necessary reforms.

This conviction defines both the content and the structure of this book. A large proportion of it is devoted to the Economic and Monetary Union. The fact that the EMU remains very far from anything resembling the optimum currency area is easily forgotten when the unemployment goes down and the GDP is on the rise. But it will resurface when the next crisis occurs, and certainly it will occur. This is why Chapter 1 retells the story of the Eurozone crisis, to demonstrate how naïve its original assumptions were. Chapter 2 then explains how and why the economic coordination in the Eurozone has not worked, either before or after the sovereign debt crisis. Chapter 3 elucidates on the distributional effects (both economic and political) of adjustment processes propelled by the sovereign debt crisis, while Chapter 4 demonstrates how all of this has put an excessively heavy burden on the ECB. Chapter 5 discusses the possibility of establishing viable economic shock absorbers capable of stabilising the monetary union when its countries are hit by so-called asymmetric shocks, while Chapter 6 makes an argument why a partial disintegration of the Eurozone would actually strengthen economic integration more broadly.

The remaining four chapters explain why fixing the Eurozone will not secure Europe's prosperity. I first argue in this part that European economic integration critically hinges on national socioeconomic policies, which in many countries have been failing conspicuously. Politicians are understandably reluctant to admit this, but Europeans see it quite clearly. As unveiled by a recent survey of the European Commission, 'almost eight in ten [survey participants] agree there is a need for significant reforms to improve the performance of their economy (78%), while 76% agree governments need to save more today to prepare public finances for the ageing population … More than nine in ten think the health system (92%) and the labour market (91%) in their country need reforms, 89% say this about the pension and education systems and 87% about the social security system. Almost eight in ten (79%) say this about taxation and 66% say this about market reforms.'[15]

Although this survey was restricted to Eurozone countries only, the results can hardly be predicted to differ much outside of it. For reasons elucidated in Chapter 7, the potential of the European project to improve Europeans' lives has lain unexploited by barring the EU from making a meaningful difference in all of these areas. As Chapter 8 will explain in more detail, it does not take new Treaties or a bigger EU budget to make up for this crucial loophole.

To complete the picture, the last two chapters investigate why both the internal market (Chapter 9) and the paradigm of maximum liberalisation of international trade (Chapter 10) require alterations mitigating their deleterious side effects. While the reforms involve some

[15] European Commission, Flash Eurobarometer 446 'The Euro Area', December 2016, 5, available at http://ec.europa.eu/COMMFrontOffice/publicopinion/index.cfm/ResultDoc/download/DocumentKy/76001.

hard choices, they are politically more feasible and justifiable than is routinely admitted.

None of the reforms putting European economic integration back on track is riskless. None is costless. Each is made more difficult by the fact that European democracies have become increasingly thin[16] and that national politicians guard the gates of EU policymaking. Each entails distributional effects likely to attract heavy resistance, enticing policymakers to continue with their time-inconsistent muddling-through. If this prevents the European Union from reforming its economic policies, the system may collapse, ushering in a painful resetting process. If this is what happens, the project born to relieve national political orders from their suicidal proclivities[17] will return to the point of departure.

Ultimately, therefore, if the integration project is to be relieved of the wasteful self-destruction gene, it must be based on robust foundations responding to what Europeans need and care about. Otherwise Europe will be entrapped between an unviable integration and a self-defeating disintegration. This is the ultimate reason why the paradigms behind European economic policies should be reassessed and recalibrated. This reason agitates every single thought in this book.

[16] I.e., institutionally and politically insufficiently robust to viably pursue policies improving the socioeconomic foundations of a society's prosperity and stability.
[17] Alan Milward, *The European Rescue of the Nation-State* (London: Routledge, 1992).

1 The Eurozone's Original Sins

1.1 Incomplete Political Vision

Politics and key economic advancements are often two sides of the same coin. The exceptional confluence of political interests and priorities prevailing in France and Germany in the 1980s, on the one hand, and the idea of the Economic and Monetary Union, on the other, is a testimony to this finding. The French President François Mitterrand famously wanted the single currency as a way of elevating the culture of monetary stability and economic prosperity associated with the Bundesbank to the European level. He reckoned that this fundamental yet simple institutional alteration would channel enhanced German economic prowess, expected only to grow after German reunification, for the good of the other Community nations – the French in particular.[1] He wanted, therefore, what German Chancellor Helmut Kohl also yearned for, and what the European project had codified in its genes since its very beginning: to harness German economic ambitions and potential for the benefit of a united Europe.

Kohl, in turn, was aware that the single currency would lock in exchange rates. By the same token, it would make it easier for German exporters to compete on international markets with producers from the other Community countries, in which recurring devaluations had previously boosted price competitiveness (while the Deutsche Mark was

[1] See esp. Karl Kaltenthaler, *Germany and the Politics of Europe's Money* (Durham, NC: Duke University Press, 1998); Kenneth H. F. Dyson and Kevin Featherstone, *The Road to Maastricht: Negotiating Economic and Monetary Union* (Oxford: Oxford University Press, 1999); Harold James, *Making the European Monetary Union* (Cambridge, MA: Harvard University Press, 2012), Markus K. Brunnermeier, Harold James and Jean-Pierre Landau, *The Euro and the Battle of Ideas* (Princeton, NJ: Princeton University Press, 2016).