GOVERNANCE IN THE EUROPEAN UNION – APPLYING THE 'TRILEMMA OF GLOBAL POLITICS'[a]

Gábor Vigvári, Corvinus University of Budapest

ABSTRACT

The European Union with its sophisticated institutional system is the most important regional integration on Earth. This tight form of economic integration converges to the level that Dani Rodrik calls hyperglobalization in his model, the political trilemma of globalisation.

In our paper we develop the mentioned model and then we apply it to the case of the European Integration. We argue that if we want to maintain the deep integration among member states in the EU we have to pass more and more functions of the nation states to the federation level. In case of the EMU that means that federal fiscal policy is needed which could lead to multi-speed Europe considering new member states' reluctance to give up their specific institutions.

I. INTRODUCTION

In his paper published in 2002 Dani Rodrik writes about the trilemma of global politics. (Rodrik, 2002) The concept is further developed in his books (Rodrik, 2008; Rodrik, 2011). The concept is based on the monetary trilemma or impossible trinity of the Mundell-Fleming model which states that it is impossible to have pegged exchange rate, autonomous monetary policy and free capital flows in the same time. This impossible or unholy trinity as Cohen (1982) calls it is further developed by Lawrence Summers (1999) and applied mainly on the financial system.

In his model Rodrik assumes that from the three desired element of world politics: deep economic integration, the nation state, and democratic politics only two can be chosen. We can either choose deep integration and the nation state but then we have to abandon democracy; or we can choose deep integration and democracy, but then we have to forfeit the nation state; or we have to circumscribe globalisation to maintain democracy and the nation state.

As Rodrik describes globalization as deep economic integration, in our paper we will think about the European Union as a form of globalization on regional level. In the European Union (EU) we can see the development of a single market with free flow of capital, labor, services and goods. Meanwhile in the Economic and Monetary Union (EMU) we can also see the development of a common monetary policy. That means that the countries of the European Union and especially the Economic and Monetary Union are involved in deep economic integration.

Meanwhile, since the outbreak of the global economic crises of 2008 the EMU (Eurozone) has been in crises. First came the recession which was managed by Keynesian tools in most countries. After that came the debt problems of the so called PIGS (Portugal, Ireland, Greece and Spain) countries. In these cases the PIGS countries seemed to be unable to finance their government's debt. And in case of Greece, Ireland and Portugal external help was needed.

The possible collapse of these countries can cause severe problems in the whole European Union. There are possible negative effects on the exchange rate of the common currency (Euro) but also the collapse can hit the European financial system as many banks and insurance companies bought up the troubled assets issued by the governments of PIGS countries. The problem therefore needs to be solved but the mechanism of the solution is debated by the actors of the European Union.

In our paper we argue that the crises we are witnessing nowadays is actually an economic governance crises of the European Union. Therefore the long term solution brings us far beyond the single crises of the PIGS countries. The real solution is the further development and improvement of the economic governance in the

---

[a] Supported by TAMOP-4.2.1/B/09/KMR-2010-0005

For useful constructive comments and suggestions, I am grateful to the anonymous reviewers and B&ESI Conference Participants; all errors remain mine

EMU. Though, in our paper we don't seek the answer on the question "what to do?" but on "how to do it?". As in the EU rules of governance can be understood both on federal/regional level and on nation state level the possible question is how to divide the responsibilities between the individual member states and the integration? These problems point further than economic theories or economic policy making as they concern sovereignty of member states, possible sacrifices of own tax revenues, and fiscal independence.

As the problem is a problem of governance not only economic issues emerge with the analysis, but there are also sensitive political issues both on national and international level, which calls for the method of international political economy (IPE). Therefore in our paper we use the concept of Dani Rodrik to enlighten the political problems of the desired solution. In the next section we briefly explain why the Economic and Monetary Union has been in trouble since 2008. In this section we also overview the suggested solutions. We could conclude from this section that we have a governance problem in the EMU, which is not only an economic but a political issue. In the second part of the paper we introduce the concept of the trilemma of global politics and describe how we adopt it to the European Union. We will point out that the question in the EU is how member states can deepen their economic integration. We will argue that we either can maintain member states sovereignty but than market forces will ensure the rules of the game or member states should engage themselves in political integration as well. A third option would be to put constraints on economic integration. In the third part we synthesize the first two parts and try to differentiate possible scenarios based on Rodrik's idea. In our conclusion we conclude that after the crisis the possibility for a multi-speed Europe has a growing chance. In our analysis we cannot show all things and solutions to solve the crisis as the policy making in the European Union hasn't been finalized yet.

II. THE CRISES OF THE ECONOMIC AND MONETARY UNION – CRISES OF ECONOMIC GOVERNANCE

Before the economic crisis of 2008 it seemed that the Economic and Monetary Union of the European Union is a success story. Beside some minor problems from which maybe the most important were the fiscal crises of France and Germany the Union was stable. But after the shock of the financial collapse of the American financial system and the recession followed it the weaknesses of the EMU came to Earth.

The first problems hung together with the financial crisis and the recession. After the collapse of Iceland the alarm signals came from Britain (where the banking system seemed to be in trouble) and from Eastern European member states (Hungary and Romania where due to the lack of fiscal credibility the governments had to turn to the IMF for financial help). But then at the turn of 2009 and 2010 after the bad news coming from Dubai a new country's name appeared in the news: Greece. Soon after that a new and maybe harsh phrase was created: PIGS for Portugal, Ireland, Greece and Spain, sometimes this is augmented with another "I" stands for Italy.

Why are these countries in trouble? After taking the firs look onto them one would say they are all the same: they have fiscal problems. (See figure 1!)

But as we can see even in figure 1 these countries were not the same before the crisis. The southern member states of the EU never have had sound fiscal policies, they were archeotypes of fiscal alcoholism. But Ireland was different. In the 1990s she was not the archeotype of fiscal alcoholism but the successful fiscal consolidation (See Benczes, 2008). Therefore we can presume that behind these fiscal problems the underlying factors are different. In this chapter we shortly overview these cases and try to prove that the main causes behind these crises are (beside internal governmental failures) governmental problem in the Economic and Monetray Union and the whole EU as well.

If we take a look on other figures, we can see the real causes. In case of Greece what we see is that this country really has done some serious errors. But we also should know that these errors should have been prevented by European Institutions. The Stability and Growth Pact was created to make it impossible for member states to weaken the common currency with running high fiscal deficit. This could be possible (and this was especially the case in Greece) because after the introduction of the Euro the long run interest rates (measured with the yields on 10 year government bonds) converged to the German level. That meant that fiscally undisciplined countries could indebt themselves in a relative easy and inexpensive way. In case of Greece the observed governance problem is that the fiscal rules that supposed to strengthen the EMU malfunctioned.

The case of Ireland is more difficult. After the successful economic reform and stabilization the Irish economy grew rapidly with almost 10% but even in the mid 2000's with an average 6% according to the Eurostat database. In the mean time long time interest rates (as in the case of the other member states as mentioned before) fell to the range between 4% and 5%. In this economic environment the Irish economy showed the signs of overheating. Lending to the private sector grew, a housing bubble emerged. The banking sector used an increasing amount of foreign assets. The country's private foreign debt reached the amount more than 8 times of its annual GDP! (Artner, 2009: 1) And after the outbreak of the 2008 financial crisis the Irish financial system collapsed and the Irish government had to spend its money to bail out banks. That led to a fiscal crisis.

As we see the governance problem here is twofold. The first is that although the Irish banks do business in a single European market the financial supervision is still on national level which can lead to problems in the banking sector. The second one (which is a common problem for almost all of the PIGS) that the interest rates set in Frankfurt by the common monetary policy are inadequate for emerging member states. In an environment of (for them) slow interest rates their economies could overheat which could lead to a hard landing, or there could be a temptation for their governments to indebt themselves by running high fiscal deficits. In a low-interest-rate environment the other problem can be inflation. Inflation rates were considerably higher in the PIGS countries than in other EMU member states. High inflation rates lead to the strengthening of the real exchange rate and this means losing competitiveness. This happened not only in Ireland, but also in Greece and Portugal (see the works of Blanchard, 2006 about Portugal and Arghyrou, 2006 about Greece!). (For data see figure 2, 3 and 4!)

In the other two cases we can observe the same pattern. In case of Portugal the most serious issue was the lost of competitiveness after joining the Eurozone together with too large government spending. (Blanchard, 2006) In case of Spain the situation is more likely to Ireland with a housing bubble. (For detailed analysis of the origin of the crisis see Baldwin et al, 2011)

To sum up: these problems show that the crises of EMU member states are not only their fault. It is also a coordination (governance) problem. As the examples show the Eurozone is not an optimum currency area. (Mundell, 1961) Or to formalize it more strictly, as Underhill (2002) argues, it is an "unfinished business" (ibid: 34) That is why it can happen that in case of good fiscal policy a country cannot avoid economic problems. So if we want to reform governance in the EMU we have to make the Union more likely to an optimum currency area. What are the possible options?

Asymmetric shocks are the source of policy failures in a monetary union. Although the 2008 crisis hit all member states because of their different economic situation this shock was different on each. That's why we can assume that this crisis was actually an asymmetric shock. The important question is what kind of mechanisms are there to eliminate the effects of asymmetric shocks on member states.

The first possible channel could be the labor market. If it is flexible enough in the whole EMU asymmetric shocks can be eliminated through migration. But as Fidrmuc (2003) shows in his study the labor market isn't flexible enough. People in the member states rather withdraw themselves from it instead of moving to another member states. This is the main difference between the United States, where people are more likely to move ie. From Florida to California, and the EU where Greek workers don't want to, and because of the linguistic difficulties actually cannot, move to Sweden.

Another possibility is the financial system. But just as it's the case with labor market the financial system is neither a solution. As Stavrev shows it, the financial market in the EMU are only partially capable to cope with financial shocks. Further integration is needed to improve this by 20% (Stavrev, 2008: 159). Similar evidence is found by Mongelli (2002). He finds, though, that economic openness, the diversity of production and consumption can help in absorbing shocks.

The factors mentioned above cannot be easily influenced by policy decisions. The immobility of European workers can be fixed only in long run. The efficiency of the financial market can be improved only partially and only in long run. The last factor is maybe the only one which can be changed in the short run and quite easily. That one is the fiscal policy. In case of the United States beside migration, the financial markets and other factors the federal redistribution of fiscal policy is the key factor in eliminating the negative effects of asymmetric shocks. The mechanism is twofold: first the redistribution can help member states in troubled times, second, the federal budget and issuance of federal bonds function as a risk sharing pool that makes it easier for member states to cope with external shocks. (Melitz, 2004). To understand the importance of common (federal level) fiscal policy let's see a quick example.

California is one of the member states of the United States that are in deep fiscal trouble. It's situation is a mix of Greece and Ireland. (Pew, 2009) Why can't we see articles in the Financial Times or Wall Street Journal about the possible collapse and end of the US dollar as we can see about the Euro? There are two reasons: the level of fiscal redistribution and the existence of federal level funding through US Treasury Bonds. Although the US federal government was able to commit itself credible to the no-bail-out rule (meaning that no federal funds can be spent helping out a troubled member state) Laubach (2005) shows that through the federal budget the implicit help is noticeable. This was even strengthen by the Obama administration's American Recovery and Reinvestment Act of 2009. The act provides an extra $140 billion for member states. (McNichols – Johanson, 2010: 8)

Beside the optimum currency area question the other governance failure was (as we saw) the inappropriate surveillance of member states economic policies. For the stability of a currency not only a proper monetary policy is needed but a mix of policies from fiscal policy to financial regulation. In the EU these policies are carried out almost exclusively by the member states and not by a federal government. That makes it necessary to constrain member states policies by some measures. According to economic and political economy theory this is especially the case in fiscal policy as that is influenced by politics which could lead to imperfect outcomes.

Therefore it is reasonable to put a rule based constraint on fiscal policy (see for example Kopits – Symansky, 1998; Kopits 2001), and in case of federal states (and in the case of the EMU we talk about something similar) this is even more true (Kennedy – Robins, 2001). The reason behind that is that a member state, using the strong common currency, facing relative low levels of interest rate, high level of trust, can indebt itself easily. This is kind of a free rider problem which can be solved with such a rule. The EMU made such a rule which we know as the Stability and Growth Pact established in the Treaty of Amsterdam 1997. According to the rule the member states' budget mustn't exceed 3% of their GDP and their national debt must be under 60% of their GDP. The Pact (a fiscal rule in a "regional state") was criticized by many scholars (see Annett et al., 2005, Buti et al., 2003, Leblond, 2006, Tanzi, 2004). These critics referred to the potential inflexibility of the rule (in case of Greece the rule seemed but rather too flexible) and the lack of enforcement (that can be proved easily by the cases of French and Germany in 2001 when they both exceeded the maximum level of fiscal deficit and were not punished). The failure of Greece put the weaknesses of the GSP back in the spotlight. There should be a more strict and enforceable fiscal rule concerning EMU member states.

But the case of Ireland shows that a country with sound fiscal policy can fall into trouble, too. But the signs of a potential crisis and the overheating of its economy were noticeable as we saw earlier. Therefore we can assume that there should be warning systems for other macroeconomic indicators, like inflation rates, current account balances, private debt levels, etc…

An optimal solution could be the establishment of a modified version of a European Monetary Fund first suggested by Mayer (2009) and Gros and Mayer (2010). If constructed this Fund could work as a "Super Fiscal Authority" in the EMU. Let's see what kind of problems the fund could resolve!

The needed sources of the Fund can be raised by issuing a European Bond with which the desired risk sharing pool system would be established. Why is such a tool necessary? In their article De Grauwe and Moesen (2009) prove that in case of a financial crisis investors seek safe havens for their investment. In such a case the demand for more risky assets would fall because investors would buy safer ones. That would put extra pressure on weaker states and push them into more trouble. A common bond would solve this problem. In such an asset every member state would hold a part (ie. according to their share in the European Investment Bank) and the financing of weaker states would be resolved.

Another resource for the fund would be penalties from countries which earlier needed help from it (Gros and Mayer, 2010). This might sound as a surprise but it is reasonable. Countries facing with difficulties might have engaged themselves adopting bad policy measures (like running too high budget deficit). To avoid moral hazard these bad policies need to be sanctioned.

The Fund could also manage fiscal surveillance and with that function we can even fix the flexibility problem of the former EU level fiscal rule. Wyplosz (2002 and 2005) argues that instead of fiscal rules (like the SGP) the EMU should form a fiscal authority that supervises member states' fiscal policies. Such a commission or board could oversee fiscal policies of member states and put constraints on them individually according their economic positions. Moreover this board could look after not only fiscal but other policies of member states like we suggested above.

The only problem that the EMF could not solve is the fiscal federalism problem. To finally eliminate the problems rooted in the OCA criteria the EU should increase the importance and redistributional potential of the common budget. The establishment and operation of EMF is a governance problem alone. But the creation of fiscal federalism would mean that member states put an increasing level of their sovereignty into the hands of the European Union. Therefore if we would like to examine how this can happen we have to use the tool of international political economy. The introduction of political analysis, the introduction of bargaining and power issues are needed to give a proper analysis on this issue.

III. THE POLITICAL TRILEMMA OF DANI RODRIK

As we noted in the introduction, the concept of the political trilemma rooted in the concept of the impossible or unholy trinity of monetary policy based on the famous model of Mundell and Fleming. In this trilemma decision makers should make a choice between pegged exchange rates, free capital mobility and autonomous monetary policy. Even this trilemma we can use in the case of the EMU. According to the Single European Act approved in 1986 capital mobility should have been liberalized between EU member states while most of them were members of the European Monetary System. According to the unholy trinity the member states lost their ability to use monetary policy as an autonomous tool to govern their economies. From this point of view it is rational to give up monetary policy and put it one level higher and create common monetary policy on federal level.

Lawrence Summers (1999) and Dani Rodrik (2002) develop further this theory using the unholy trinity method for the analysis of the relationship between national sovereignty and globalization. Summers' concept is based on financial liberalization and capital mobility, while Rodrik's on institutional convergence. In our paper we will use Rodrik's model but as the conclusion is the same in Summers' paper we could have used his version either.

As we mentioned earlier in the introduction according to Rodrik's model if we would like to achieve full globalization (economic integration) we either have to abandon democracy or the nation state. Now this concept should be explained more detailed so we can adopt it to the European Union.

Rodrik defines globalization as deep economic integration where there are no transaction costs concerning international economic activities. Beside well-known economic policy tools like tariffs and other non-tariff barriers there are other possible constrains on economic globalization which raise transaction costs. These are the differences of non-market institutions in different countries. Gilpin (2001) describes three different national system in the world economy: the American, the Japanese, and the German. According to Gilpin these are different because of different institutional solutions concerning "(1) the primary purposes of the economic activity of the nation, (2) the role of the state in the economy, and (3) the structure of the corporate sector and private business practices" (Gilpin, 2001: 149). Of course we might differentiate between a lot more national system in the world economy but this concept of Gilpin rhymes to that one of Rodrik. Because of this diversity to reach full economic integration these differences between non-market institutions should be eliminated. This can be done in two different ways.

We can either maintain the nation state or democracy. If we choose the former that means that each nation state have to have the same non-market institutions. In this case the different non-market institutions will converge to each other: according to Gilpin's definition (Gilpin, 2001: 183) in this case the differences are eradicated by the market. As Rodrik borrows Thomas Friedman's term the market forms a golden straitjacket and bound economic policy and the functioning of non-market institutions. In this case governments have no choice they have to adopt themselves to this straitjacket and have to set up market friendly institutions and introduce something like that what Karl Polányi calls self-governing markets (Polányi, 1944/2004). That means that policy choices are circumscribed therefore we cannot talk anymore democracy: states do not have the possibility to choose their non-market institutions freely. The term golden straitjacket roots from the era of the gold standard: at the end of 19th and the beginning of the 20th century we could have been the witness of the so called "first globalization" when the world economy functioned like the golden straitjacket describes it.

The other way is to maintain democracy, in other the worlds to freely decide what kind of institutions we want to use. But in this case we have to decide that globally that makes it impossible to maintain the nation state. In Rodrik's term we can talk about some kind of global governance where policy and institutional decisions are made on a global level. Now we can differentiate between two different solutions in this political trilemma. Of course we have a third option that Rodrik calls the Bretton Woods compromise.

In the third case we say that we don't need full economic integration therefore we can maintain the nation state and democracy. Rodrik borrows the name from the Bretton Woods system which existed from 1944 until 1971. During this time period there were several constrains on economic globalization. First, convertibility was limited: during the whole time on the capital account but for a long time also on the current account. Second, the international treaties and institutions created during the Bretton Woods Era followed the same norm that John Gerald Ruggie (1982) called embedded liberalism. This term means that countries first focused on full-employment, stability, welfare, growth at home and only after reaching that they focused on liberalizing their outward policies such as trade or capital flows. In other words they limited globalization to reach stability at home.

If we put together all this, we get the final version of Rodrik's trilemma which we can illustrate as figure 6! Although we only can say that we are not able to choose all the three edges of this triangle at the same time we might ask the question which solution is more desirable from the three possibilities? Rodrik thinks that the best solution is to circumscribe globalization and choose the Bretton Woods compromise. He argues that global governance isn't possible in our times. And he also put aside the golden straitjacket version. He states that for the whole world it is a wrong solution as the convergence in non-market institutions harms less developed countries wou should be able to choose their own way of economic policy making. We can only add to this argument the conclusion of Karl Polányi in his famous book, The Great Transformation (Polányi 1944/2004): he says that self-governing markets never work, which means that the golden straitjacket version could lead the catastrophic consequences like he observed in the 1930s and 1940s.

How can we apply this model to the European Union and especially on the Economic and Monetary Union? In the case of this integration of 27 countries we can observe a growing economic integration with the introduction of the four freedoms (freedom in capital flows, labor force mobility, the mobility of goods and services), hence economic globalization on a regional level. This is even more true in the case of the EMU where even some more common policies are introduced, the most important one is the common monetary policy.

According to the model of the political trilemma we are getting closer and closer to full economic integration. That means that on the level of the integration the member states have to deal the next question: if they want to reach this full economic integration they either have to abandon democracy or forfeit the nation state: which means they have to form a federal state, like the United States of America. Or, of course, there is a third possibility: they can circumscribe their economic integration.
Our paper argues that the present crises of the European Union evolved because its member states cannot choose between these possibilities. In the next section we try to enlighten the possible scenarios.

IV. POSSIBLE SCENARIOS

In this section we would like to argue that the solution of Europe's crisis is to decide which outcome we'd like to reach in the political trilemma of the integration. The member states have three options as we pointed out earlier. Now let's see the detailed versions of these possibilities!

The first, and according to our view less likely, option is to apply the golden straitjacket to the Economic and Monetary Union. In this case the basic rules of stabilization, market governance, enforcement of long term equilibrium would be enforced by the market. That means in countries with chronic external or internal imbalances the market would signal the problem and enforce the prober policies. In this case in the EMU the mechanism would involve adjustment in price levels as the adjustment through exchange rates is impossible. This mechanism could have hard social impacts as deflation usually enforced by decrease in wage levels.

As Leblond (2006) argues in his paper concerning the Stability and Growth Pact (SGP) in the past there were no fiscal crises in the Economic and Monetary Union despite the fact that the rules of the SGP were broken many times. As Leblond argues that is because the market will sign if the fiscal policy of a country is unsustainable.

Leblond was aware that this can only happen if the following conditions are fulfilled (Leblond, 2006: 979):

> "First, markets must be reasonably open so that investors have a large range of investment opportunities and are not dependent on the sovereign borrower.
> Second, information about the borrower's fiscal situation must be transparent, i.e. it must be accurate, complete and easily available.
> Third, there must be no expectations by market participants that the borrower will be bailed out should it not be able to service its debts.
> Fourth, the borrower must respond to market signals."

During the time period Leblonde examined in his study these prerequisites were fulfilled. Five years later we know that this argument is only partially true. In case of Germany and France all of the four points mentioned above were true. But as we saw in the case of Greece markets can be misled by lying governments. The second problem with this approach is that in case of market enforcements signs come usually late and overreacting or overshooting. Therefore if we entrust only markets to govern the Economic Monetary Union we would see lots of crises with tragic social impacts. As for foreign economist until now Europe was a synonym of social capitalism both political elites and society would hardly ever accept this kind of solution of the problem.

Therefore we think that the other two possible ways are more likely to happen. Which are these possibilities? The first one is to maintain economic integration and democracy but that means that the member states should give up a growing part of their sovereignty and engage themselves in global governance, which means in this case regional governance. The other solution is to give up parts of economic integration to maintain democracy and the nation state.

First let's see the first possibility. In this case we choose the global governance solution of the trilemma. When talking about the European Union global governance means policy decisions made on the integration level. First we have to investigate in what kind of way this integration level policymaking can be carried out? Of course the ideal type of this integration-level-governance should be a federal state like the United States with its own elected government and parliament. Of course as things are standing right now this is rather a utopia than a possible scenario. But if we take a look on the real world and in the meantime also on integration theories we might see that global governance in this sense can work and is working right know, although with some serious constraints.

Concerning federal level governance in the EU we might say that there are two main functions of that. The first function of that what we might call operational decision making: using the given rules and competence. We might call that the executive branch. The second function is making new rules, decision making procedures. We might call that the legislative branch. As we showed above we think that the cause of crisis in the Eurozone is that the existing rules are not good enough. That is why we have to concentrate on the second function of governance.

The second function is basically equivalent to the decision about the deepening of the integration. Therefore we can discuss it using integration theories as these try to interpret the process mentioned above. There are two leading theories of regional integration concerning the European Union. The first one is neofunctionalism developed by Ernest Haas.

The neofunctionalist theory basically suggest that the deepening of the integration is fostered by (1) intraintegrational institutions such as the European Commission or the European Parliament and (2) by business and other interest groups within the Union. As Andrew Moravcsik puts it in his article (Moravcsik, 1991: 24-25)

> "In The Uniting of Europe, Ernst Haas distinguishes between processes of integration that take place at what he called the "supranational" and "national" levels. Three key elements of the supranational process are the ability of a central institution (the European Commission) "to assert itself in such a way as to cause strong positive or negative expectations," the tendency of "business and labor ... to unite beyond their former national confines in an effort to make common policy," and the "demonstration by a resourceful supranational executive that ends already agreed to cannot be attained without further united steps."

In case of the Eurozone neofunctionalism means that the whole process of monetary integration can be seen as a self reinforcing mechanism (Dyson 2002a: 9 – 10, see figure 5!):

> "In EMU the key feedback loops might be visualized as between loss of autonomy in economic and monetary policy making, EMU rule-making and procedures, performance in macroeconomic convergence, and elite identity with EMU. The synergy between globalization and the single European market in the 1980S laid the foundations for EMU. In globalized financial markets, characterized by the free movement of capital, EU governments are more constrained in monetary policy. They are also threatened by potential disruption of internal EU trade by exchange-rate instability and potential adverse policy interactions in an increasingly interdependent economic area, with negative consequences for employment and growth. New rules and procedures to stabilize and then irrevocably fix exchange rates and coordinate other policies offset the costs of this reduced autonomy in economic and monetary policies. These new rules and procedures for EMU in turn force governments to reappraise what they can best do in domestic economic policies, especially by containing unit labour cost development and prioritizing structural economic reforms. A second feedback loop is between EMU rules and procedures and economic convergence. There appears to be a correlation between increased economic convergence and new EMU rules and procedures. New rules and procedures, like exchange rate coordination and then a single monetary policy, serve in turn to underpin and reinforce convergence. Equally, convergence increases confidence that these new rules and procedures can be made to work in the general interest. A third feedback loop involves a greater identity of national officials and central bankers with the institutional mechanics of EMU as it becomes clear that key decisions are being taken there. The more identity shifts to the European level, the readier officials are to endorse closer rules and procedures to strengthen coordination. This greater identity feeds back into greater compliance with EMU rules and procedures. Improved compliance feeds back in turn into a readier acceptance of macroeconomic coordination. Hence EMU appears as a self-sustaining process, characterized by a parameter shift in the period 1985-9. During this period the launch of the single market programme and increased economic convergence associated with the Exchange Rate Mechanism (ERM) set in process a complex set of interactions that led to a dynamic growth of EMU rules and procedures and of elite identity with EMU."

The idea of neofunctionalism suggests that traditional methods of international and transnational policy making, negotiations change. More and more functions of the nation state are put on the level of integration. In this interpretation neofunctionalism means that the short run political interests of states won't influence the decision making of the integration and the "legislative" functions. The integration is not a bargaining process among equal nation states but an automatic or semi-automatic process. The theory lost its explanatory power after the empty chair crisis in 1965 – 1967 when France vetoed the British accession to the European Community. During this crisis the negotiation position of France was influenced by its own national interest: the maximization of income from the Common Agricultural Policy. (Gilpin 2001: 352 – 354)

This occasion pointed out the weaknesses of earlier theories: the neglect of national interest. After this a new theory of the European integration emerged: the theory of intergovernmental institutionalism. This theory, which later was simply called intergovernmentalism in many major textbooks (like Gilpin, 2001) was developed by Andrew Moravcsik in the 1990s. According to Moravcsik (1991: 25 – 26) the three key elements of his theory are:

1. Intergovernmentalism: according to Moravcsik the most important actors are the nation states. "Heads of government, backed by a small group of ministers and advisers, initiate and negotiate major initiatives in the Council of Ministers or the European Council. Each government views the EC through the lens of its own policy preferences; EC politics is the continuation of domestic policies by other mean." (ibid: 25)

2. Lowest common denominator bargaining: As there is no hegemon in the European integration, negations always reflect the current relative power positions of the member states. Small states are usually bought off with side payments while larger states can veto significant changes. Therefore bargaining moves toward the lowest common denominator of large state's interest.
3. Protection of sovereignty: Joining the integration means that a nation state has to sacrifice a part of its sovereignty in exchange of grants from cooperation, this case the integration. Thus nation states are interested in maintaining their sovereignty therefore "policymakers safeguard their countries against the future erosion of sovereignty by demanding the unanimous consent of regime members to sovereignty- related reforms. They also avoid granting open-ended authority to central institutions that might infringe on their sovereignty, preferring instead to work through intergovernmental institutions…" in case of the European integration "the Council of Ministers, rather than through supranational bodies such as the Commission and Parliament." (ibid: 26)

If we take a look at this theory it is clear that is belongs to the so-called neoliberal institutionalist approach of international political economy. This school of IPE acknowledges that nation states are the most important actors in the world economy. They are rational actors and try to maximize their utility which mostly can be measured by the change in their power. The intergovernmentalist theory considers regional integrations (including the European Union) as a regime. The theory of international regimes has a huge literature (see Krasner, 1983; Keohane, 1984; or for a later more comprehensive one Hansclever – Mayer – Rittberger, 1997). International regimes are "sets of implicit or explicit principles, norms, rules, and decision-making procedures around which actors' expectations converge in a given area of international relations" (Krasner 1982: 186). According to the definition regimes change if the principles or norms of the regime change.

Changes and cooperation in international regimes are explained by several theories; though according to this neoliberal institutionalist approach these are the states that change their behavior because of their national interest. Now according to the neoliberal institutionalist approach states are "black boxes" meaning that we can only assume that the changes in their behavior are caused by changes in the distribution of power among them. In the intergovernmentalist approach however states are no longer black boxes: "they are entities entrusted to governments, which themselves are responsible to domestic constituencies. State interests change over time, often in ways which are decisive for the integration process but which cannot be traced to shifts in the relative power of state." (Moravcsik, 1991: 27) National interest can be traced back to internal politics. That, however, doesn't change the fact, that according to this intergovernmentalist approach European governance can be described as a bargaining process, where domestic politics of the member states play a very important role.

Until the entry into force of the Lisbon Treaty the Council of Ministers was the main legislative force of the European Union. In that time it was easy to argue, that the intergovernmentalist approach of integrationist theories was the best one: although many suggestions came from the European Parliament or the Commission the final vote took place in the Council. Nowadays this is a little bit different, as the European Parliament got more power as a legislator. We cannot be sure how this will affect the bargaining about the solution of the Greek (and Irish, Portuguese, Spanish) crisis, and which way the new economic governance of the EMU will be built up. But, as the Council is an institution, in which the representatives of national governments sit intergovernmental bargaining still plays a large role. This means that if we want to talk about global/regional governance in the European Union we still have to consider it as kind of a regime with all of the consequences.

The third option would be to give up economic integration and maintain sovereignty and the nation state. In our case this would mean giving up the common currency. We can interpret it in two different ways: first it can may that only the problematic countries drop the Euro and re-introduce their own old currencies. In this case the losers would be the investors who bought a large amount of these countries' assets as they would lose their value. Of course there would be also internal problems but most of those could happen without the withdrawal. The second case could be a total breakup of the Eurozone. We think that this solution could have enormous consequences not only for the European Union, but for the whole world economy. Therefore we take out this second possibility from the research.

V. STRONGER AND TIGHTER ECONOMIC GOVERNANCE – A MULTI-SPEED EUROPE?

The idea of multi-speed Europe means that different countries of the European Integration engage themselves in different level of integration. The case of Economic and Monetary Union might be seen as one of this issue. However, with the two exceptions of Great Britain and Denmark all other countries promised to join the Eurozone as soon as possible after their EU accession. If this pledge could be enforced than we hardly could talk about multi-speed Europe in this case.

But after the outbreak of the Eurozone's crisis the picture is different. The crisis put the problems of economic governance into the spotlight and the leaders of the Eurozone have to choose now among the three possible scenarios. As we mentioned in section 4 the possibility of using the golden straitjacket is quite low. The other two scenarios depend on the decisions made by the national governments.

First let's consider the last option from the previous chapter: leaving the Eurozone. As we mentioned earlier leaving the Eurozone can be costly for both the one that leaves and for those who stay. Leaving the Eurozone would result in high rate of inflation, bankruptcies in the financial sectors. This would certainly hurt the country's economy and society. But a potential exit would also mean the acceptance of default on the public debt which could cost a lot to the lenders as well. On the other hand if a country tries to continue paying back its debt that would cost also a lot because of the fiscal restrictions. Therefore we might argue that quitting the Eurozone is at least as costly for the rest of the member states as for the country in trouble. And as today we do not have any mechanism that handles quitting it is quite unlikely that it would happen.

Now let's talk about global governance in the European Union. We showed in the previous chapter that when we talk about governance in the EU we have to talk about the executive and legislative functions. When we think about fixing the economic system of the EMU the first thing is to repair the old institutions and to build up new ones. In case of the legislative function the major decision making body is still the Council of Ministers and the European Council. In case of the later the European Council is a new institution that "defines the general political direction and priorities of the European Union" however "[I]t does not exercise legislative functions" (Homepage of the European Council). The European Council consists of the Heads of State or Government of the Member States, together with its President and the President of the Commission. The High Representative of the Union for Foreign Affairs and Security Policy takes part in its work.

The Council of the European Union or the Council of Ministers is the main legislative body of the European Union. "The EU's laws are made by the Council, together with the European Parliament. In most cases, the Council can only legislate on the basis of proposals submitted to it by the European Commission" (Homepage of the Council of the European Union). That means that still after the Treaty of Lisbon was signed, new institutions or reforms of former institutions might be made by the governments of the EU.

If we accept the logic mentioned above we can see that the legislative function of the European governance still works according to the logic of intergovernmentalism. That means, that member states keep their eyes on their national interest when making decisions about the future of European integration.

There are several conceptions within regime theories that try to explain how norms and rules evolve and change in these institutions. The more liberal conception is that nation states recognize that if they cooperate and adhere to rules they agreed on, they all share benefits from it. Realists are more pessimistic about cooperation and rule making and say that this is only possible, if there is a hegemonic state that "supervises" other states behavior and lays down the rules of cooperation. As we mentioned earlier, intergovernmentalists are in between that two views. Small states are usually bought off with side payments while larger states can veto significant changes. Therefore bargaining moves toward the lowest common denominator of large state's interest.

If we take a look at recent happenings in the European Union concerning the problems in the Eurozone, what we can see is that the proposed solutions including institutional changes and bail-out packages were subject of bargaining processes. These discussions were mostly prevailed by Germany and France the two largest country of the Eurozone. We do not want to present all the suggested solutions. What is important however to see that all of these suggestions would decrease member states sovereignty. What makes it even more painful is, that member states' fiscal policy will be circumscribed. But as fiscal policy is dominated by politics and political goals, therefore it is very painful for a politician to give up the control on it.

VI. CONCLUSION

Therefore we can conclude that after the outbreak of the Eurozone's crisis we have to reconsider the theories and policy recommendations about joining the Eurozone. There is a huge literature about the timing and policy questions about EMU accession. But these papers were mostly based on an economics-based cost-benefit analysis: the economic gains of the introduction of the common currency and the potential costs of the lost of common monetary policy and the costs of the convergence process (potential fiscal reforms and the cost of disinflation).

According to our analysis these cost-benefit analyses should be augmented with other factors as well. As we showed earlier there is one more likely and one less likely solution to the crisis of the Eurozone. First let's deal with the less likely one. We can call that the exit strategy and it belongs to the Bretton Woods compromise solution of Rodrik's trilemma. Exit means leaving the Eurozone and using the former national currency. Of course this strategy is only for those EU members that are already using the Euro. According to our view this strategy is a very dangerous one and has huge possible costs. Therefore we think that it will be used only in emergency cases and only be countries that are serious trouble and default on their debts. For instance in case of Greece the potential exit would hurt its creditors not just the country itself, and in case of the exit it is sure that

Greece would default. According to our view exit could be a strategy for heavily indebted countries of which governments cannot or do not want to cope with the situation.

The other option was an enhanced model of global governance on the level of the European integration. That means that those countries who want to (1) stay, or (2) enter into the Eurozone have to introduce new institutions that decrease the level of their sovereignty, especially in fiscal policy. This has of course economic implications that have to be built into the models mentioned above. But beside economic implications this decision also has political dimensions. Politicians could feel they lost important tools of policies like taxation, social policies etc… Therefore joining the Eurozone has growing political costs for member states who don't have introduced the common currency yet. Signs of that are already visible: the turning down of signing the new Euro Plus (or Competitiveness) Pact by Hungary and the Czech Republic beside of Sweden and Great Britain shows that new member states are more and more skeptical about joining the EMU. It is also problematic for several member states (and also for EU institutions like the ECB or the Commission) that several reform packages were suggested by Germany and France while other member states were excluded from these negotiations.

Beside the political costs the crisis also pointed out that the introduction of the Euro has more economic costs than earlier expected; or these cost were earlier underestimated. The case of Ireland, Spain and Portugal all suggest that real convergence can hurt a member state's economy with relative high inflation and loss of competitiveness, or because of overheated economy. Therefore it is likely that non-member states will postpone the introduction of the common currency.

This entire have the possible implication that those non-member states whose governments won't bear the economic and especially political cost of the introduction of the Euro will postpone their accession. Therefore it is possible that for quite a long time there will be several member states with less engagement toward economic integration. And this process could lead to an explicitly multi-speed Europe.

ANNEX

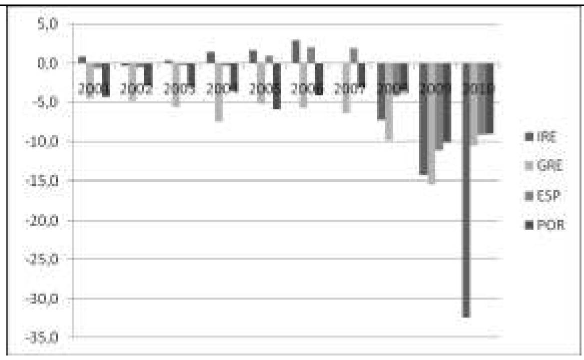

Figure 1: Government deficit/surplus – percentage of GDP (source: Eurostat)

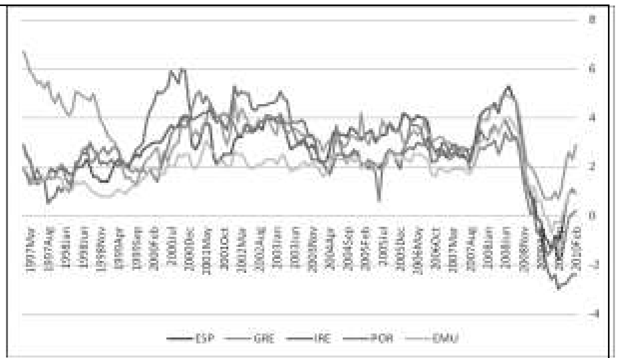

Figure 2: Inflation rates in PIGS and EMU average (source: ECB)

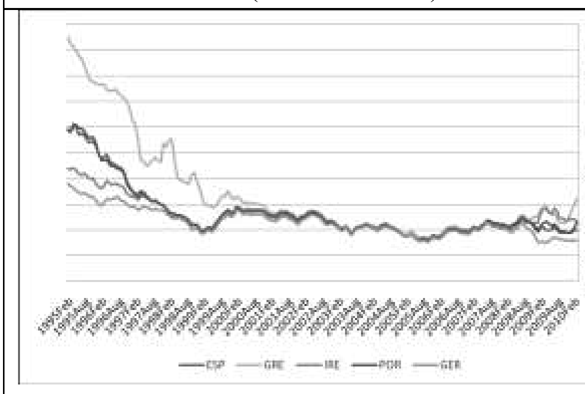

Figure 3: Long term interest rates in PIGS and Germany (source: ECB)

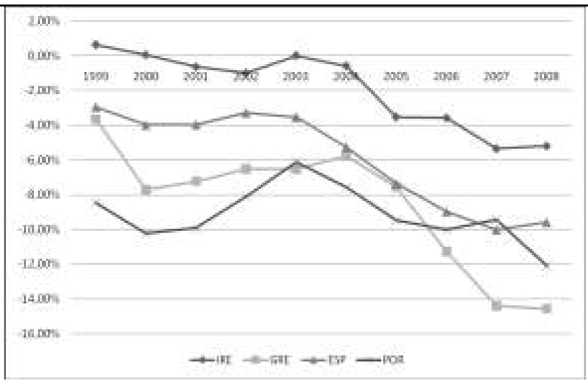

Figure 4: Balance of payments in PIGS as percentage of GDP (source: Eurostat)

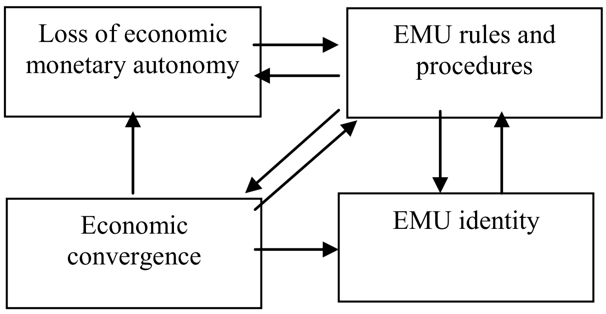

Figure 5: The Eurozone as a self-reinfrocing mechanism. Source: (Dyson 2002a: 10)

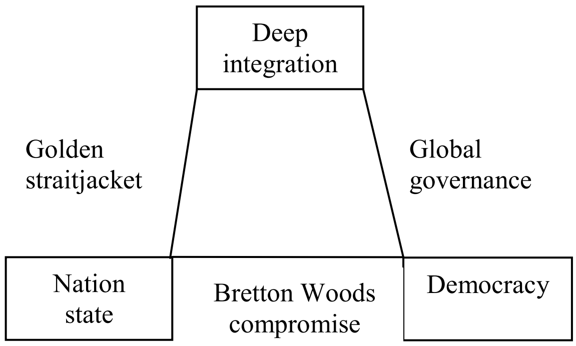

Figure 6: Rodrik's trilemma of global politics, based on Rodrik (2002 and 2007), own drawing

REFERENCES

Annett, Anthony – Decressin, Jörg – Deppler, Michael (2005.): "Reforming the Stability and Growth Pact" *IMF Policy Discussion Paper, PDP/05/02*

Arghyrou, M. G. (2006): "The Accession of Greece to the EMU: Initial Estimates and Lessons for the New EU Countries", *Liverpool Quarterly Economic Bulletin*, 27 (4), December 2006 http://www.cardiff.ac.uk/carbs/econ/arghyroum/qeb_MA.pdf Retrieved: 11.05.2011

Artner Annamária (2009): "Válságkezelés Írországban" *Köz-gazdaság* 4 (4) 81 – 93

Baldwin, Richard et al (eds) (2011): *Completing the Eurozone Rescue*. VoxEU.or eBook

Benczes, István (2008): Trimming the Sails. CEU University Press, Budapest – New York

Blanchard, O. (2006): "Adjustment Within the Euro Area. The Difficult Case of Portugal". *MIT Department of Economics Working Paper, No. 06-04.*

Buti, Marco – Eijffinger, Sylvester – Franco, Daniele (2003.): "Revisiting the Stability and Growth Pact: Grand Design or Internal Adjustment?" *CEPR Discussion Paper No. 3692.*

De Grauwe, Paul – Moesen, Wim (2009): "Gains for All: A Proposal for a Common Euro Bond" *Intereconomics* (44.) 3 132-135

Dyson, Kenneth (2002a): "Introduction: EMU as Integration, Europeanization, and Convergence" in: Dyson (2002b) 1 – 27

Dyson, Kenneth (ed) (2002b): *European States and the Euro. Europeanization, Variation, and Convergence* Oxford University Press, Oxford

Fidrmuc, J. (2003.): "Optimal Path into the EMU: Big Bang or Gradualism?" In: Karl Aiginger and Gernot Hutschenreiter (eds.): *Economic Policy Issues for the Next Decade*, Kluwer Academic Publishers, Boston, 2003, 123-140.

Gilpin, Robert (2001): *Global Political Economy* Princeton University Press, Princeton

Gros, Daniel and Thomas Mayer (2010), "Towards a Euro(pean) Monetary Fund", Policy Brief 202, Centre for European Policy Studies (CEPS), Brussels, February.

Hansclever, Andreas – Mayer, Peter – Rittberger, Volker (1997): *Theories of international regimes*, Cambridge University Press

Homepage of the Council of the European Union: http://www.consilium.europa.eu/showPage.aspx?id=&lang=en

Homepage of the European Council: http://www.european-council.europa.eu/

Homepage of the European Central Bank: http://www.ecb.int

Homepage of Eurostat: http://epp.eurostat.ec.europa.eu/portal/page/portal/eurostat/home/

Kennedy, Suzanne – Robbins, Janine (2001.): *The Role of Fiscal Rules in Determing Fiscal Performance* http://dsp-psd.communication.gc.ca/Collection/F21-8-2001-16E.pdf Retrieved: 02.05.2008

Keohane, Robert O. (1984/2005): *After Hegemony: Cooperation and Discord int he World political Economy*, 2nd Edition, Princeton University Press

Kopits, George – Symansky, Steven (1998.): *Fiscal Policy Rules* International Monetary Fund, Washington DC

Kopits, George (2001.): "Fiscal Rules: Useful Policy Framework or Unnecessary Ornament" *IMF Working Paper*, 145, 2001 September

Krasner, Stephen D. (1982): “Structural Causes and Regime Consequences: Regimes as Intervening Variables”, *International Organization* 36 (2): 185 – 205
Krasner, Stephen D. (eds.) (1983): *International Regimes*, Ithaca: Cornell University Press
Leblond, Patrick (2006.): “The Political Stability and Growth Pact is Dead: Long Live the Economic Stability and Growth Pact” *Journal of Common Market Studies*, (44.) 5 969-990
Laubach, Thomas (2005): “Fiscal Relations Across Levels of Government int he United States” *OECD Economics Department Working Papers No. 462*
Mayer, Thomas (2009): “The Case for a European Monetary Fund” *Intereconomics* (44.) 3 138-141
McNichol, Elizabeth – Johnson, Nicholas (2010): “Recession Continues to Batter State Budgets; State Responses Could Slow Recovery” Center on Budget and Policy Priorities http://www.hapnetwork.org/assets/pdfs/hen/cbpp-recession-report.pdf Retrieved: 29.04.2011
Melitz, Jaques (2004): “Risk Sharing and EMU” Journal of Common market Studies, 42(4): 815 – 840
Mongelli, Francesco Paolo (2002): “»New« views on the optimal currency area theory: what is emu telling us” *ECB Working Paper No. 138*., 2002 April
Moravcsik, Andrew (1991): “Negotiating the Single European Act: National Interests and Conventional Statecraft in the European Community” International Organization 45 (1) 19 – 56
Mundell, R. (1961): “A Theory of Optimum Currency Areas” *The American Economic Review*, (51) 4 657-665.
Pew Center on the States (2009): *Beyond California. States in Fiscal Perlil* http://www.pewcenteronthestates.org/report_detail.aspx?id=56044 Retrieved: 03.05.2011
Polányi, Karl (1944): *The Great Transformation* in Hungarian: Polányi Károly (2004). *A nagy átalakulás* Napvilág, Budapest
Rodrik, Dani (2002): “Feasible Gloablizations” *NBER Working Paper No. 9129*
Rodrik, Dani (2007): *One economics, many recipes, Globalization, institutions, and economic growth*. Princeton and Oxford: Princeton University Press
Rodrik, Dani (2011): *The Globalization Paradox: Democracy and the Future of the World Economy* W. W. Norton and Company, New York
Ruggie, John G. (1982): “International Regimes, Transactions, and Change: Embedded Liberalism in the Postwar Economic Order” *International Organization*, 2: 379–415.
Stavrev, Emil (2008): “Transmission Channels, Risk Sharing, and EMU Dispersions” *Czech Journal of Economics and Finance*, 58(3-4) 152 – 165
Summers, Lawrence (1999): “Distinguished Lecture on Economics in Government: Reflections on Managing Global Integration” *The Journal of Economic Perspectives*, 13 (2): 3 – 18
Tanzi, Vito (2004.): “The Stability and Growth Pact: It’s Role and Future” *Cato Journal* (24.) 1-2 57-69
Underhill, Geoffrey R. D. (2002): “Global Integration, EMU, and Monetary Governance in the European Union: The Political Economy of the 'Stability Culture'” in Dyson (2002b) 31 – 52
Wyplosz, Charles (2002): *Fiscal Discipline in EMU: Rules or Institutions?* http://hei.unige.ch/~wyplosz/gea_0402.pdf Retrieved: 30.04.2011
Wyplosz, Charles (2005): “Fiscal Policy: Institutions versus Rules?” *National Institute Economic Review*, No. 191, 2005. január http://hei.unige.ch/~wyplosz/niesr0105.pdf