HEGEMONY WITHOUT STABILITY: THE FISCAL AND POLITICAL VULNERABILITIES OF MONETARY UNION

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Abstract: The crisis has forced the Euro area to establish an emergency fund that supports member states experiencing a sovereign debt crisis. The difficulties of coming up with such a fund for Greece and other Euro area members stands in marked contrast to the balance of payments support that non-Euro members like Hungary received, swiftly and quietly. In order to solve this puzzle, we first establish the difference between EU interventions and IMF programs and, second, trace the evolution of crisis management with France and Germany in the lead. The lens of hegemonic stability theory suggests that the Franco-German leadership is too weak to provide stability and the extensive use of conditionality is one symptom of this weakness. Providing incentives for cooperation 'after hegemony' (Keohane) is the unresolved issues troubling the monetary union. Its dominant powers must acknowledge that markets perceive monetary union to be already politically more integrated than its lack of fiscal integration suggests.

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Introduction: Towards hegemonic stabilization of the monetary union?

The crisis has forced the Euro area to establish an emergency fund that supports member states experiencing a sovereign debt crisis. In May 2010, the member states of the Euro area decided to establish a European Financial Stability Facility (EFSF), which will be turned into the permanent European Stability Mechanism (ESM) from mid-2013 onwards. It took the European Council of heads of state several weeks before they could agree on any support for other members of the monetary union. By contrast, the EU gave loans to stabilize their balance of payments to non-EMU members of the EU like Hungary and Latvia as early as November 2008 and January 2009, respectively (Lütz and Kranke 2010). Support measures to EMU members and non-members alike were closely coordinated with the IMF which put in a considerable amount of its own resources.

The quick response to Hungary's troubles was based on Article 143 TFEU that allows assistance to EU members outside the Euro area. A faster response to the Greek sovereign debt crisis, raging only since December 2009, was hampered by the so-called 'no-bail-out' clause of Article 125 TFEU that stated that neither the Community nor any Member state shall 'be liable for or assume the commitments of' another Member State'. The obstacle could only be overcome when, under ever more intense market pressure, German and Dutch negotiators (in particular) gave up their resistance and Article 122 TFEU could be invoked. This bailout clause allows Community Financial Assistance to be extended to 'a Member State [which] is in difficulties or is seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its control'. In order to comply with this legal wording, Greek public finances had to be seen as a victim of the banking crisis. At worst, the Greek government's fiscal policy could be said to have made public finances 'vulnerable' to such an event beyond its control.

This interpretation, required in order to comply with the letter of the Treaty, was contradicted by the acrimonious debate about Greece's failings and policy mistakes. No such public debate ensued with respect to Hungary, even though the government there could be accused of similarly reckless behaviour (Bremmer 2011}, with a deficit deemed excessive ever since 2004. The invoking of the bailout clause for events beyond a government's control was also contradicted by subsequent reforms of economic governance, introducing more, faster and quasi-automatic sanctions for 'excessive' deficits, debt and current account imbalances. These reforms are based on the diagnosis that a lack of fiscal discipline is to blame for the Euro crisis since 2010. By contrast, no institutional reforms were contemplated in response to the travails of Hungary or other non-Euro area countries.

This is the puzzle we are after in its simplest form: Why are there these differences between Greece and Hungary? Why do member states find it more difficult to extend credit to a Euro area member than to a non-member? After all, the creditors' immediate self-interest must be to stabilize a shared currency. When they do, why is the rescue so much more contested in European capitals than the support to the intransigent administration in Budapest? Why did governments in France and Germany feel they needed to speak with one voice after the Greek crisis had broken? The quiet technocratic policy of liquidity support for the new EU member states arguably did the job and stabilized currency and bond markets there. Why has the Greek crisis spread capriciously to other members and why could crisis management at the highest political level not avert turmoil that jeopardizes the very existence of the monetary union?

Our approach to answering these questions rests on a comparison of EU interventions with those of the IMF. Many commentators draw from the IMF's role in maintaining the Bretton Woods system the implication that the Euro area needs its own IMF (Gros and Meyer 2010).

Some see the new institutions now being created in the Euro area (the EFSF and the ESM) as fulfilling this role. But what exactly does that role entail? And is it compatible with basic tenets of the EU's political-economic constitution such as formal equality of members, irrespective of whether they are net contributors or recipients of budgetary resources? In the IMF, voting powers go with the (historical) share of members in subscribing funds. Program countries have to accept particular constraints on their sovereignty in return for financial resources, whereas the constitution of the EU imposes common, symmetrical constraints on all member states.

To develop our comparison we can draw on an older literature that was concerned with the stabilization of international monetary relations, triggered by the break-down of the US dollar standard of the early post-war years. Kindleberger (1973) suggested that international monetary stability requires a hegemonic power as the anchor of the system. Historically, the hegemon of an international monetary system provided the public good of stability in three main ways. One was to act as a lender of last resort in times of serious crisis, a second was to resolve problems of incipient sovereign insolvency by providing credit on more favourable terms than private capital markets, and a third was to facilitate adjustment to redress fundamental imbalances, particularly by preventing a slide into protectionism. Crucially, in Kindleberger's account, the hegemon does not overtly exploit its power to pursue its own immediate interests: a strategy of 'dominance'. Indeed, in order to establish and maintain authority, the hegemon must give up short-term own interests and even visibly bear costs. Sympathetic critics of hegemonic stability theory like Keohane (1984), Eichengreen (1987) and others stress the need for cooperation among a relevant sub-set of countries, for international stabilization efforts to be both effective and legitimate. The hegemon's presence may greatly facilitate mutually beneficial coordination, but rarely does a hegemonic power have enough leverage on its own to stabilize a system. This insight shifts the focus on the

institutionalised incentives of secondary countries to cooperate and maintain an asymmetric regime (Keohane 1984: 39). On this account, hegemony orchestrates coordination but does not replace it.

This account of hegemony – in particular, the distinction between hegemony and dominance – is important in understanding the IMF's role in managing global financial stabilisation. For some, it is obvious that the IMF is an agent of the US's dominant power. The US has effective veto power on the IMF's Executive Board, and, it is claimed, it has used this power to ensure that IMF policies promote US geopolitical and economic interests.[1] A focal point for this account is the 'Washington Consensus', the label Williamson (1982) attached to an orthodox set of views about structural economic reform, comprising policies such as removing price controls, deregulating financial markets and liberalising trade. Gould traces the adoption of structural reform conditions in IMF lending programmes, looking for examples of 'micro-conditionality' backed by detailed performance criteria. She finds that, '[w]hereas in the 1950s, 1960s and 1970s the Fund would have simply established macroeconomic targets and remained agnostic about how a government reduced its deficit (for instance, its burden on the poor), by 1988 the Fund required much more specific policy enactments.' (Gould 2006: 72). To support these conditions, the Fund provided technical assistance to determine 'for instance, which taxes should be cut and how', and also remained involved with the borrowing country for longer periods while reforms were being implemented.

However, Gould also produces evidence that raises doubts about the equation of conditionality with US hegemony. Indeed, Washington could be found advocating lax conditions for countries it regarded as strategically important (Gould 2006: 113).

[1] These claims are reviewed in Lütz and Kranke (2010: 4).

Williamson's own account of the Washington Consensus suggests that US influence was not necessarily the main factor behind its adoption (Williamson 1982: 48-52). Other explanations include Kapur's (2001) argument that conditionality changed as the direction of lending moved from developed to developing countries. This argument may help to explain why, since its damaging intervention in the East Asia crisis (where governments in rapidly advancing countries bitterly resented the terms of IMF intervention), the IMF has turned away from structural conditionality and back to the bread-and-butter business of macroeconomic adjustment. Gould's own theory is that conditions reflect the preferences of supplementary creditors, which nowadays means primarily private financial institutions. The IMF imposes conditions which reassure the markets and allow countries to resume access to private capital flows. This resonates with Stone (2002) who interprets the role of the IMF as one of 'lending credibility' to countries making the transition to capitalist market economies.

The importance of all these interpretations of the relationship between US hegemony and IMF conditionality is that they suggest that the detailed structural conditionality of the Washington Consensus did not reflect the preferences of the hegemon. If anything, such conditionality reflected the weakening of the hegemon and the need to design programs that would satisfy private finance. Furthermore, structural conditionality can be imposed on developing countries with weak governmental institutions (albeit with questionable success), but its imposition on more advanced countries, like those of East Asia, is risky for the legitimacy and authority of the lending institution.

This is the background to our comparison of IMF and EU lending to Hungary and Greece. Broadly, our findings accord with Lütz and Kranke's account of 'the European rescue of the Washington Consensus'. In its approach to lending to Hungary, a developed country despite some weaknesses in its public institutions, the IMF stuck essentially to macroeconomic

conditionality. The EU, however, linked its conditions to those of the already-existing Excessive Deficit Procedure (EDP) for Hungary. Its detailed conditions reflected the parameters of the Stability and Growth Pact (SGP), a sort of Washington Consensus for Europe. In fact, it is a Frankfurt Consensus in that its stipulations clearly reflect the decisive preferences of the German Treasury and the Bundesbank, imposed in return for giving up the D-Mark. But the travails of the SGP since 2000 have shown us the difficulties of imposing detailed conditions on democratic and notionally equal states. Following Keohane (1984), we can see that the international regime created in 2000 did not get the incentives for self-enforcing compliance right, not even for Germany, which was one of the first countries to violate the Pact. The SGP was reformed in 2005 and became a deliberative, low-key process rather than the disciplinarian device that was once envisaged (Schelkle 2007, 2009). Thus a more reflective route to cooperation was sought.

We examine the move from a soft, symmetric SGP to the hard world of conditional lending with clear asymmetry between creditor and debtor countries. Our lens relies on the contrast between hegemony and dominance. Recall that the hegemon underpins the system and avoids the appearance of nakedly exercising power in its own interests. The hegemon has the capacity to exercise leadership to coordinate resources to act as lender of last resort and supplier of liquidity, even if it does not have (all) those resources itself. By outlining the evolution of Franco-German initiatives in crisis management and reform of economic governance, we raise doubts about whether this is hegemonic leadership in the making. This in turn presents issues for the new ‘regional IMF’ institutions: the ESM and the EFSF. The two countries want to limit the resources of these funds which invites continuous speculation about whether their resources are adequate. Satisfying private finance through conditionality is therefore essential to the stabilisation effort, however asymmetric and anti-democratic it may seem. Yet, this manifestation of weak hegemony is very unlikely to provide stability.

Our paper proceeds as follows. In the next section, we compare the conditionality attached to the Hungarian loan with that stipulated in the Greek rescue package. We then examine whether and how Europe might develop the institutions to provide stability. As noted above, this means covering the three elements of acting as lender of last resort, providing sovereign solvency resolution and facilitating structural adjustment. The concluding section reviews the evidence and draws out the implications for our thinking about the political economy of monetary integration. Whereas many commentators have seen political integration following from closer fiscal integration, the Greek crisis in the Euro area shows that they are separate processes and that political integration may precede closer fiscal union.

Lending programs inside and outside the monetary union: short-term fix or transformation?

This section first compares the circumstances leading up to the Hungarian and Greek requests for international financial assistance, the form that assistance took and the conditions imposed on the two sovereign borrowers. As Table 1 shows, in 2008 the economic position of Greece appeared to be worse than that of Hungary in every respect except growth; the fiscal situation was not fully known at the time. Public debt stood at under 70 percent of GDP in Hungary, compared with an estimated 94 percent in Greece (later revealed to be over 100 percent, as shown in the table below). Hungary's current account deficit ran persistently at 6-8 percent of GDP throughout the 2000s, while in Greece the current account deficit reached more than 16 percent of GDP in 2008. Yet despite its less dire situation, Hungary turned to international institutions for assistance long before Greece, requesting a Stand-By Arrangement (SBA) from the IMF in October 2008, while Greece did not request assistance from the IMF and the EU until May 2010.

Table 1: Select comparative data for Hungary and Greece

		Hungary	Greece
Current account balance	**2007**	-7.0	-15.6
(in % of GDP)	**2008**	-6.9	-16.3
	2009	-0.4	-14.0
	2010	1.7	-11.8
Real effective exchange rate[a]	**2007**	149.7	108.5
(1999=100)	**2008**	151.5	111.5
	2009	135.1	112.5
	2010	134.6	109.7
Budget balance	**2007**	-5.0	-6.7
(net lending of general government)	**2008**	-3.6	-9.8
(in % of GDP)	**2009**	-4.3	-15.6
	2010	-4.5	-10.4
Public debt	**2007**	66.1	105.4
(in % of GDP)	**2008**	72.3	110.7
	2009	78.4	127.1
	2010	80.2	142.8
Real GDP growth	**2007**	0.8	4.3
(change in %)	**2008**	0.8	1.0
	2009	-6.7	-2.0
	2010	1.2	-4.5

Source: AMECO database, IMF for real GDP growth

a A measure of the change in the competitiveness of a country, by taking into account the change in nominal exchange rates and in domestic prices relative to 27 main trading partners. A rise in the index means a loss of competitiveness.

Why did Hungary come under pressure first? In October 2008 liquidity problems were endemic in the global banking system as a result of the failure of Lehman Brothers. Hungary's particular problems were two-fold. Non-resident investors were disposing of their forint-denominated government bonds which made the value of the currency decline precipitously. At the same time, the household sector was exposed to foreign currency risk, as households had taken out mortgages denominated in Swiss francs and euros to avoid high forint interest rates. Hungarian banks proved not to be adequately hedged against a forint depreciation. The dual exposures meant that the currency could not be allowed to depreciate freely (although it did fall substantially in real as well as nominal terms, as Table 1 shows). Thus the primary function of support from the IMF and the EU was to stabilise the forint.[2]

[2] This account is based on IMF documents, particularly the Ex-Post Evaluation prepared by a staff team in June 2011 (IMF 2011).

The simple reason why Greece turned to the IMF and EU much later than Hungary was that the foreign exchange market issues that affected Hungary could not arise in Greece under the single currency. Banks did not suffer from mismatched foreign currency exposures, households were not indebted in other currencies, and, of course, there was no currency depreciation to stabilise. Greek banks did face liquidity problems because of Greece's adverse balance of payments position, but they were able to deal with these problems by turning to the exceptional bank liquidity support then being supplied across the Euro area by the ECB. In particular, they could present their holdings of Greek government bonds at the ECB's discount window.[3] Greece's problems started when the ECB began to signal, late in 2009, that these that these exceptional measures would soon come to an end (Trichet 2009).

Looking at established fiscal governance arrangements, Hungary had been under an Excessive Deficit Procedure (EDP) continuously since 2004, which meant it was under close monitoring by the Commission on behalf of the Council. Greece had been under an EDP from 2004 to 2007; it re-entered an EDP in July 2009.[4] As we show below, the prior existence of these institutional arrangements influenced the EU's approach to loan conditionality.

The Hungarian package

The amount requested by Hungary from the IMF was huge: SDR 10.5 bn, or 1015 percent of Hungary's quota, calling 'exceptional access' arrangements into play. These required four criteria to be met. There had to be exceptional balance of payments pressures on the capital

[3] The ECB also made available its lender-of-last-resort facilities to Hungarian banks, in the form of the Refinancing Guarantee Fund. However, the banks were unable to access these facilities because of the low rating of Hungarian government debt. Instead the government extended loans to the banks, to the disapproval of the IMF (IMF 2011: 25), and possibly at odds with EU state aid rules.

[4] For the sequence of events and reports, see http://ec.europa.eu/economy_finance/sgp/deficit/countries/greece_en.htm

account, but at the same time the Fund had to satisfy itself that debt would remain sustainable, that access to private capital markets would be restored, and that the policy program had a reasonable chance of success (IMF 2011: 9-11). The IMF duly documented that Hungary had long-standing fiscal and external imbalances, along with other 'pre-crisis vulnerabilities', notably foreign currency lending to households. These facts could have produced the assessment that Hungary's problems were structural and persistent rather than temporary and exceptional. However, the Fund acknowledged that it had not foreseen the stress on the banking system that currency depreciation would produce. It emphasised the liquidity (as opposed to solvency) issues faced by the banks, and also the problem of contagion (IMF 2011: 6, 8). In other words, the Fund framed Hungary's problems as arising from special and unanticipated circumstances.

The loan conditions developed by the Fund were limited: 'streamlined conditionality' in IMF jargon. A simple cash-based deficit criterion was established, focused on achieving a quick reduction in the government's financing needs (Government of Hungary 2008). The IMF's Ex Post Evaluation recognised that this left scope for the government to meet the performance criterion by postponing payments, accruing arrears to suppliers and workers (IMF 2011: 14). These are familiar problems with fiscal targets, and the failure of the loan conditions to guard against them suggests that the Fund's preoccupation was with getting immediate results rather than producing long-term reforms.

The IMF conditions for Hungary fell into three categories: performance criteria, indicative targets and structural benchmarks. The former are the most binding: approval of the IMF Board is needed to waive these criteria and release further tranches of funding. As noted, a quantitative performance criterion for the government's cash balance was set, along with an indicative debt stock target. In addition, a 'structural performance criterion' of submitting a

bank support package to Parliament was imposed, along with structural benchmarks on the passage of fiscal responsibility and bank resolution laws (Government of Hungary 2008: 8).

The EU joined the IMF rescue package, agreeing to provide up to €6.5 bn or about two thirds of the IMF commitment. Some of the substance of the EU agreement matched that of the IMF, although the formalities were presented differently. The Memorandum of Understanding between the Commission and Hungary specified policy actions that had to be undertaken for the release of each tranche rather than performance criteria that had to be achieved. The first EU tranche depended on freezing public sector wages, eliminating 13th month salary payments, and capping the 13th month of pension payments. These specific actions are mentioned in the Hungarian government's Letter of Intent to the IMF (para 10), but they are not conditions for future disbursements. Fiscal conditions for subsequent tranches referred to the submission of budget plans as well as outturns, whereas the IMF focused on outturns. The IMF specified these in cash terms, while the EU specified deficit limits as percentages of GDP, in accordance with the monitoring methodologies developed under the SGP and in the operation of EDPs. Fiscal outturns were to be verified by Eurostat, whereas the IMF could use monetary flow data to verify compliance with the deficit cash limits more quickly (but more roughly). In short, the EU adopted an approach which promoted processes of sound budgeting, accurate financial reporting and ongoing fiscal monitoring.

Apart from the more elaborate methodology, there were also more conditions in the Hungary-EC Memorandum of Understanding (MOU) than in the IMF program.[5] For example, structural reforms to reorient labour market programs towards more active policies figured in

[5] The full list of IMF structural conditionality can be found in IMF 2011, Table 4; the EU conditions can be found in Memorandum of Understanding (2008).

the conditions for the second instalment from the EU, while longer-term improvements to the sustainability of the pension system were part of the set for the fourth instalment. These conditions, along with others, were drawn from recommendations already developed under Hungary's EDP. In other words, the EC linked its participation in the rescue package to its longer-term promotion of fiscal stability, whereas the IMF specified a much narrower set of measures, primarily concerned with re-establishing banking sector liquidity, reforming bank regulation and establishing a sounder fiscal position.

The IMF and EU teams were not to have the satisfaction of signing off a successful program. As Table 1 shows, the nominal depreciation of 2008 produced a real depreciation which was sustained in 2009-10, and this apparently reaped quick rewards in an improvement in the current account position. The restoration of growth in 2010 also improved the fiscal prognosis. But in July 2010, the IMF and the EU took the unusual decision to suspend Hungary's credit line in disapproval at the policies of the newly-elected Fidesz government. The IMF staff team's Ex Post Evaluation in 2011 treads carefully around this political conflict. It notes that the initial program was negotiated with a minority government, and that this political weakness called for 'efforts to build broad political consensus' (IMF 2011: 4). The minority government fell in April 2009, having never recovered from the discrediting revelations in 2006 that it had lied 'morning, noon and night' about the country's fiscal and economic position.[6] It was replaced by a 'technical government' led by Gordon Bajnai and supported by the socialist and liberal parties, which adopted the measures specified in the loan agreements.

[6] The then prime minister, Ferenc Gyurcsany, was taped when he gave a candid speech about the election campaign, available at URL: http://news.bbc.co.uk/1/hi/world/europe/5359546.stm (accessed October 19th, 2011).

The Fidesz government ended compliance with the program by removing the independence of the Fiscal Council, dissolving the established body and creating a new one populated with party loyalists (Bremmer 2011). It also reduced the independence of the Central Bank and cut the salary of the Governor. It proposed a financial sector tax, unilaterally adjusted the repayment terms for household mortgages, and abandoned the commitment to achieve a 3 percent deficit in accordance with EU SGP parameters.

Despite an adverse response from the ratings agencies, which cut Hungary's rating almost to junk bond status at the end of 2010, economic growth has helped to prevent a new financial crisis so far in 2011. The IMF has simply brought its program to an end, while maintaining 'post-program surveillance' to ensure it gets its money back. For the EU, matters are more complicated. Several of the measures taken by the new government breach EU rules. While the fiscal deficit in 2011 is projected to be within the 3 percent guideline, projections suggest deteriorating prospects, and the Council recommended in July 2011 that the government take steps to improve its fiscal position (Public Finances 2011: 54-55). However, there is no financial leverage to this recommendation: while the EU's assistance has not been fully disbursed (€5.5 billion of the planned €6.5 billion has been paid),[7] the lending facility expired in November 2010.

Rescuing Greece

As noted above, the immediate impact of the financial crisis on banking and public sector liquidity and solvency in Greece was not felt because of its membership of the monetary union. However, since December 2009, there was uncertainty about whether the ECB would cease to accept Greek bonds. It appeared that, if Greek government bonds were downgraded by the ratings agencies, then ECB funds would not be available. In the end, this did not come

[7] See URL: http://ec.europa.eu/economy_finance/eu_borrower/balance_of_payments/index_en.htm

to pass, but the prospective scaling back of ECB intervention was sufficient to unnerve the markets. The impact was felt not on external transactions of the Greek banking system, but on the financing of the fiscal deficit and the refinancing of public debt. As a result of statistical revisions and low growth, the estimated debt/GDP ratio rose to 115 percent in 2009. Projections of further increases skyrocketed as spreads increased.

The immediate reasons for the EU to provide a program for Greece were to control the contagion risk of the Greek government's financing problems onto other Euro area states with large external financing needs, to limit and cover the ECB's possible losses on its holdings of Greek debt, and to deal with the effects of low Greek bond prices and prospective default on foreign banks holding Greek bonds. These motives all come under the heading of fiscal spillovers, and there is therefore an apparent continuity between the program and the established SGP/ EDP regime. However, this continuity is more apparent than real, as the circumstances of the current crisis were not imagined by the designers of the SGP. Nonetheless, it is no surprise to find that the EU has established structural reform conditions for Greece based on themes already established in the fiscal surveillance process.

What of the IMF's approach to a program for Greece? At first sight, the Greek situation did not conform to the IMF criteria for exceptional access to a standby facility, which specifies that there must be exceptional balance of payments pressures. A fiscal deficit is not a balance of payments crisis. However, the IMF linked the two things: the staff report on the standby facility argued that 'Greece's large rollover requirements on maturing foreign obligations result in significant pressures on the capital account.' (IMF 2010: 19). The report went on to identify the threats to financial stability posed by rising sovereign debt spreads and falling government bond prices (IMF 2010: 7). In short, while there was no balance of payments

crisis as such, there were some of the effects of a balance of payments crisis on the banking system at home and among trading partners.

Plausible as these arguments might be, it remained that the IMF was stepping outside its established domain: critics argued, among them German finance minister Schäuble and Eurogroup President Juncker, that it should no more intervene in Greece than it would in California (Bundesregierung 2010, Evans-Pritchard 2010). One obvious consequence was that the Fund could not insist on exchange rate adjustment as part of its program, although this is a favoured policy when countries with their own currencies get into strife (Lütz and Kranke 2011: 8). The Fund worked within a 'framework for cooperation' with the European Commission and the ECB (IMF 2010: Box 1). It limited its engagement: whereas it was the senior partner in the Hungarian program, it was the junior partner in Greece (funds were drawn on in a 3:8 ratio IMF: EU). Even so, the IMF contribution of SDR 26.4 bn to the three year program amounts to 2,400 percent of Greece's quota. As junior partner, it did not establish its own conditionality: its conditions almost exactly mirror those established by the EU. While the IMF retained its standard framework of performance criteria and structural benchmarks, these were juggled to correspond to the EU's structural agenda and macroeconomic targets.

In the joint program established by the EU and the IMF, the fiscal deficit was the principal performance criterion, while the structural benchmarks included 'modernizing public administration, streamlining the local authorities, improving data reporting and budget framework, reforming social security, reducing risks from the state-owned enterprises, and enhancing tax administration' (IMF 2010: 19). Each of these items had previously been signalled in SGP stability programs and fiscal surveillance reports dating back to Greece's entry into the monetary union in 2001. However, as we will now show, the transformation

from monitoring process to lending conditionality produced a discernible sharpening in the language and tenor of the EU's recommendations and requirements.

Trying to monitor Greece

To trace the evolution of conditions over time, we look at three areas that can indicate a tightening of the surveillance process: first, the assessment of statistical quality; second, the underlying budgetary situation and third, the need for specific social policy reforms. The accuracy of the statistics submitted was an issue ever since 2002 when Eurostat revealed that Greece entered the Euro area on false premises: 'Following these revisions, the previously estimated government surpluses for 2000 and 2001 turned into deficits' (EC 2003: 2). This repeated itself in 2004-05 when Eurostat refused to sign off the stability programs because of incorrect reporting of financial flows with the EU and of health care and Olympics-related expenditures. There was also a regular reminder that high stock-flow adjustments, an indicator of creative accounting practices, make the assessment of debt developments very difficult. But only in February 2010, after another Eurostat report that finally alarmed financial markets, did the Commission take legal action, initiating an infringement procedure 'in relation to the non-compliance with a series of EU legal acts, concerning the compilation and reporting of fiscal statistics in Greece.' (EC 2010: 10) In the lending program in May 2010, the infringement sanction was complemented by a loss of administrative autonomy: compliance with the lending program will be subject to auditing by Eurostat and IMF officials.

The budgetary situation was a 'serious concern' ever since Greece's accession to the Euro. In the early years, the unadjusted deficit was within the 3 percent bound, but the Commission took the view that a favourable cyclical economic position concealed underlying structural difficulties. Fiscal outturns were not strong enough 'in a period when the Greek economy has

been growing at high rates' (EC 2003: 3; Council 2003: C26/4). The Commission continued to express concern in 2004, finding the fiscal stance plainly 'inappropriate' (EC 2004: 3), but the Council opinion (unusually) did not follow this wording and merely expressed doubt that the goals as stipulated by the Pact could be achieved (Council 2004: C43/8). In 2005, the assessment still pointed out inconsistencies in the Greek government's declared commitments, but thereafter the wording became rather bland. The Commission observed that 'budgetary outcomes could be worse than projected in the programme.' (EC 2007: 6; cf EC 2006: 12), and the Council accepted this formulation. Relatively positive assessments in 2006 and 2007 made the Council abrogate Greece's EDP in July 2007, only to find two years later that there was pro-cyclical 'expenditure slippage' and significant debt accumulation in 2007 (EC 2009: 4). A new EDP was opened in April 2009, based on the verdict that '[i]n 2009, the Greek public finances have worsened much beyond what could have been expected to result from the downturn and the financial-sector support measures.' (EC 2010: 7).

The difficulty for the Commission in offering these assessments was that they carried only persuasive force. The original fiscal rules had become untenable in November 2003 when the Chirac and Schröder governments pressured the Council to bend the rules so as not to open EDPs against France and Germany. At the instigation of the Commission, this bending was ruled unlawful by the Court in July 2004, a month before Greece got its first EDP.[8] The reform of the Pact that followed made fiscal surveillance a depoliticized regualtory process. The emphasis became continuous scrutiny and intensified auditing by the Commission, notably Eurostat, at the level of the civil service, avoiding stand-offs in the Council (Schelkle 2007, 2009). The hope was that Greece would mend its ways with the spread of a technical culture of fiscal monitoring and compliance.

[8] Case C-27/04, Commission v. Council, 2004 E.C.R. I-6649.

Bland and non-conflictual language is evident in the two EDPs for Greece submitted in 2005 and 2009 (Council 2005, Council 2009). They are almost identical: calling for budgetary consolidation in terms of outcomes (lower deficits and debt) without specification of policy measures to achieve these. They ask more specifically, but still not in operational detail, for control of age-related spending; the 2009 EDP adds expenditure on health care as an area of concern. The timetable for adjustment takes the Greek government's declared commitments as the binding schedule.

The lending program in 2010 brought a sharp change in this attitude of benign neglect. Fiscal performance criteria were laid down (in percent of GDP and subject to verification by Eurostat). Failure to meet the criteria could in theory result in decisions not to disburse further financial assistance, on the part of both the EU and the IMF. Furthermore, the lenders did not shy away from specifying the policy actions that the Greek government had to take. They sought a 'frontloaded' adjustment, including 'an immediate cut in the public sector wage bill, and in pension outlays, and further increases in the VAT and selected excises.' (IMF 2010: 50-51 and 74-75) The 13th and 14th salaries and pensions for public employees were to be eliminated, although for those on low pensions or incomes an annual flat rate bonus could be paid. The tax system is a particular concern of the program, with specific requests for how to make it more progressive and less prone to evasion: ''Revenue from higher income segments of society will include a boost in (presumptive) taxation on liberal professions, an increase in luxury goods taxation, and (temporary) surcharges on highly profitable entities and high valued properties as well as other measures to combat tax evasion included in the recently adopted tax reform legislation. Other revenue increases will include broadening the VAT base, increasing rates and bringing up excise taxes where Greece is below the euro area average and collection efficiency is low. Green taxes and "health" taxes

(such as on consumption of alcohol and tobacco) will also play a part' (IMF 2010: 51-52 and 75-76).

In the area of specific social policy reforms, the Commission had long pressed Greece to address the long-term sustainability of the pension system. In successive stability reports, the Commission and the Council reiterated that comprehensive and 'deep' pension reform is 'urgent' and should be tackled 'resolutely' and 'without delay'. Similar advice was given to other member states, but in a 2010 assessment the Commission ventures a criticism that others are spared: the Greek pension system is not only 'unsustainable', but also 'inequitable', despite a reform in 2008 (EC 2010: 5). Thus the Commission went beyond its established remit of speaking for the interests of future generations and questioned the current conduct of social policy. This was followed up in the lending program, which provided an opportunity to set out the measures to be taken in pensions reform in great detail. The program specifies that there must be a closer correspondence between contributions and entitlements; benefits must be indexed to prices; the retirement age should be raised to 65 and subsequently increased in line with rising life expectancy; early retirement must be constrained even for older workers, and a means-tested benefit for all retirees should be introduced (IMF 2010: 52 and 76).

In summary, the conditions inserted by the Commission in the lending programs for both Hungary and Greece show a lot of continuity with the recommendations produced by fiscal surveillance under the SGP. However, the Commission and Council seized the opportunity to attach strong conditionality to the EU loans, where previously only recommendations could be made. Furthermore, recommendations tended to follow bland and general formulations that were applied across a number of member states, whereas the loan conditions are specific to the borrowing countries.

While it is tempting to see conditionality as a sign of institutional ‘muscularity’, the experience of neither Hungary nor Greece supports this interpretation. Hungary ceased to comply with key conditions once free of its financing constraint, and the EU has little leverage to re-establish compliance. Greece, for its part, has failed to meet some of its performance criteria, but the consequences of withholding loan tranches are too damaging to permit strong enforcement.

Evolving crisis management in the EU: Hegemony or failed cooperation?

We have suggested that heavy reliance on conditionality is a sign of the absence of a stabilising hegemonic power. In this section, we pursue this hypothesis further by examining whether the major powers in the Euro area, France and Germany, have acted jointly as a hegemon in the sense of Kindleberger (1973), namely as a kind of benevolent dictator to ensure monetary and financial stability with sticks and carrots. Historically, the hegemon of an international monetary system provided the public good of stability in three ways (Eichengreen 1987): first, by facilitating adjustment to redress fundamental imbalances, second, by providing liquidity to tide countries over temporary distress and, third, by acting as a lender of last resort in times of serious crisis. We examine how each of these resources might be supplied in the Euro area, and consider whether Germany and France have facilitated or impeded their availability.

We note first that Germany and France have become more assertive about their leadership in the Euro area. Their influence is less veiled by the EU institutions now than in the past. This is evident if one looks at how Franco-German meetings have been organised and reported. The close post-war partnership between the two countries was renewed in the Elysee Treaty in 2003, on the occasion of the 40th anniversary of European integration, when Jacques

Chirac and Gerhard Schröder were in office. This treaty instituted a meeting of the French and German cabinets in spring and autumn of each year to launch projects and discuss EU matters. However, statements on EU matters were rare and were concerned with expressing joint disagreement or support for initiatives of the Commission, not with signalling Franco-German bilateral agreements to other member states.[9] In any case, the meetings became less regular under Merkel and Sarkozy, and since 2008 it is no longer the full cabinet that meets.

When France held the EU Presidency in the second half of 2008, it sought to establish Franco-German leadership in the then-unfolding financial crisis, but was rebuffed by Germany. The French summary of the crisis summit declared that the two countries came together to prepare a European strategy, while the German summary mentioned only that the two sides agreed on the need for concertation of national programs. This difference reflected the deep underlying tension between the French quest for stronger European economic governance and the German adherence to subsidiarity.

Despite these fundamentally different preferences, the two countries have, since 2009, announced what their coordinated position and reform initiatives will be at the next EU summit or G20 meeting. Thus they agreed on closer economic policy coordination and called for tighter financial regulation in March 2009 and February 2010. At various points they have also closed ranks in ruling out certain proposals such as the creation of Eurobonds by member states, and the extension of the new emergency facility, although these positions could not be sustained as the crisis deepened.

[9] For instance, Merkel and Sarkozy expressed disagreement with regards to the timetable for reducing CO2 emission of cars produced in Europe (June 2008) and support for the EU agenda of equal opportunity (November 2007). All official summaries of the meetings can be found (in German, with link to French version) at URL: http://www.france-allemagne.fr/Die-deutsch-franzosischen,0586.html

The most assertive and contentious bilateral statement was made at a Franco-German-Russian summit when the finance ministers of both countries were absent. The infamous Deauville Declaration of October 2010 was issued on the same day that the Van Rompuy Task Force of economic and finance ministers agreed on their final report regarding such reforms (EurActiv 2010). The most controversial proposal in the Deauville Declaration was a Treaty change that would allow for suspension of voting rights in the Council of members in 'serious violation of basic principles' of EMU.[10] It led to vehement protest especially by governments of smaller countries and did not become part of the reforms. The proposal can be seen as an attempt to enhance the political power of France and Germany in a way that reflected their economic power, deviating from the long-standing constitutional principle that all countries count equally in the formal arrangements of the European institutions, regardless of their economic muscle.

If we consider French and German stances in relation to the three ways of providing stability that we noted in the introduction, we get a rather negative verdict. Consider first the lender of last resort function. This is, in the first instance, fulfilled by the ECB. In the first stages of the crisis, it played this role by freely accepting bonds at its discount window. Subsequently, as we noted in the discussion of the emerging Greek crisis, it lowered the standards for the rating of bonds it would accept. With further pressure on bond prices and an element of contagion appearing in Euro area sovereign debt markets, it went further, buying up sovereign bonds since May 2010. The monetization of sovereign debt is risky for the ECB, as the debt it holds will decline in value if there is a sovereign default, so the institution makes a loss. ECB President Trichet agreed to the bond-buying program only on the condition that the member states created an emergency fund to cover these possible losses. This fund was the

[10] URL: http://www.elysee.fr/president/root/bank_objects/Franco-german_declaration.pdf'

temporary EFSF of €440 billion (Barber 2010).[11] We can see that, when insolvency threatens, fiscal authorities become the lender of last resort since they must recapitalise the central bank (Goodhart and Schoenmaker 1995).

We suggest that the ECB has been more flexible and willing to support fiscal authorities than most observers expected before the crisis. In the special circumstances of financial market meltdown, it has followed Bagehot's dictum 'In a crisis, discount freely' (quoted in Kindleberger 2000: 216). But Franco-German leadership played no helpful part in achieving this outcome, not least because the French and the Germans disagreed most of the time on what they wanted the ECB to do. The French President urged the ECB to follow the US and UK bond purchasing programs much earlier (Barber 2010) while the German Chancellor criticized the ECB for even modest unorthodox measures early on (Benoît and Atkins 2009) until it dawned on her that the ECB interventions spared Germany immediate fiscal commitments.

The second way of providing hegemonic stability, support to ensure sovereign solvency, was intended in the initial conception of the EFSF. It was meant to give a credit line to sovereign debtors temporarily unable to issue bonds at reasonable cost. The German chancellor rejected the creation of a new EU institution for this purpose (Barber 2010), hence the EFSF was set up as a 'société anonyme' under Luxembourg law, with Klaus Regling, a former German Treasury official and Director General of DG Ecfin, as its head.

The EFSF can issue bonds based on the bilateral guarantees that each member state signs up to. The share of each Euro area member state in an adjustment program is determined by its paid-up capital in the ECB. The overall amount that the member states are ready to

[11] For the official description see URL: http://www.efsf.europa.eu/attachments/efsf_presentation_en.pdf.

guarantee[12] was first given as €440 bn and amended to €780 bn in July 2011. At the request of Germany, it was decided that the EFSF should issue only bonds with top credit rating so as to reduce financing costs. In order to get this rating, not only must the guarantors be top-rated but they must also 'over-guarantee' these bonds to the tune of 120 percent.[13] The effective lending capacity of the EFSF is therefore considerably less than €780 bn (table 2). We can also see that if France lost its AAA-rating, lending capacity would be reduced by 20 percent of the notional amount of €780 bn and more than a third of the effective amount of €447.5 bn.[14] The potentially hegemonic couple can therefore not shield sovereign debtors by controlling market forces but has made itself dependent on these market forces in the form of private sector credit ratings (Mabbett and Schelkle 2010).

Table 2: Effective financing capacity of the EFSF, as of August 2011

Top-rated guarantor countries	Maximum guarantee commitment (€ bn)	Contribution key (%)
Austria	21.6	2.8
Finland	14.0	1.8
France	158.5	20.3
Germany	211.0	27.0
Luxembourg	1.9	0.3
Netherlands	44.5	5.7
Total	447.5	57.9

Source: EFSF (2011: 31), figures are rounded

The limitations to the set-up of the EFSF have led to the creation of a more robust ESM. The permanent ESM will not take over the outstanding loan book of the EFSF but will start anew as an 'intergovernmental organisation under public international law' (EFSF 2011: 32). It will have an effective lending capacity of €500 bn with a subscribed capital of €700 bn of which €80 bn will be paid in. Again, the creation of the ESM is hardly testimony to Franco-

[12] In addition and available to all EU countries, the Commission can raise up to €60 bn guaranteed by the EU budget (European Financial Stabilisation Mechanism, EFSM) and the IMF has agreed to top up each program by up to half the amount drawn from the EFSF and the EFSM but no more than €250 bn. Details of the following can be found in an official presentation of the EFSF from August 2011 (URL: http://www.efsf.europa.eu/attachments/efsf_presentation_en.pdf, accessed October 16th 2011).
[13] Top-rated means AAA in the classification of Standard & Poor's and Fitch, and Aaa in Moody's
[14] Obviously, the facility could issue lower rated, more costly bonds but the other bigger guarantors that would then become effective lenders are Italy (17.9 percent share), Spain (11.9 percent), and Belgium (3.5 percent), all countries that would be hard pressed to play that role.

German leadership. Indeed, Chancellor Merkel categorically rejected the increase in lending volume envisaged for the ESM only eight months before its foundation.

Finally, what about facilitating adjustment? It is worth reminding ourselves what the hegemon's role might be in facilitating adjustment. Foreswearing protectionism is one element, with which the Franco-German couple have broadly complied (notwithstanding some industry-supporting crisis measures that sailed close to the wind of the state aid rules). But the key way in which the hegemon can facilitate adjustment is to promote macroeconomic stability through its own fiscal policies, something that Germany, in particular, has failed to do. Instead, both countries endorsed a tougher approach to member states with excessive deficits in the Deauville declaration (see above). It required intervention from the Parliament to introduce formal symmetry in the 'excessive imbalances procedure' envisaged in the latest economic governance reforms. The permanent surplus countries, Germany and the Netherlands, vehemently opposed the creation of a symmetrical obligation to contribute to adjustment (Phillips 2011).

The 'six pack' of economic governance reforms, as the package is now officially called, consists of five Regulations and one Directive. The most important changes are the following:[15]

- To prevent a situation of excessive deficit or debt, a public expenditure benchmark has been established that says expenditure must not increase by more than trend GDP; countries that deviate strongly can be fined by up to 0.2 percent of their GDP even in this preventive section of the SGP.
- To correct excessive debt and deficit situations, defined as a debt-to-GDP ratio above 60 percent and a deficit-to-GDP ratio of more than 3 percent, sanctions of up to 0.5 percent can now be imposed after six months and the Council can reject a recommendation by the

[15] All relevant documents can be found at URL: http://ec.europa.eu/economy_finance/economic_governance/index_en.htm.

Commission a second time by qualified majority only ('reverse majority principle') although the Parliament insisted that in the first instance this principle will not apply.

- To improve enforcement of fiscal surveillance, European institutions comment and give guidance on draft budgets before they go to national parliaments (so-called 'European semester'); moreover, fines in the form of an interest-bearing deposit can now be imposed on excessive debt that is not reduced rapidly enough, for statistical misrepresentation and continuous deviation from the medium-term objective of 'close to balance or in surplus'.
- To deal with current account imbalances, two regulations specify a) an 'alert mechanism' using a scorecard of economic indicators and b) an 'excessive imbalances procedure' that asks a country to come up with a plan to correct the imbalance; but a more flexible timetable applies than in the budgetary EDP and it can be held in abeyance by the Council; if corrections are deemed inadequate, however, the new procedure can also lead to a sanction of up to 0.1 percent of GDP; at the instigation of the European Parliament, this procedure will apply to deficit and surplus countries alike.
- To improve fiscal surveillance, multi-annual fiscal planning frameworks must be introduced and statistical and accounting practices brought in line with EU standards.

A Euro+ Pact was also initiated by France and Germany and finally agreed in March 2011. It provides support for adjustment mainly in the form of policy advice, peer review and possible sanctions, but not loans or other access to funds. The whole reform package marks a return to the disciplinarian regime that Germany wanted to impose on the Euro area originally. Germany itself undermined its credibility as soon as the rules were agreed, the Kohl government by trying to fudge the debt criterion when entering EMU[16] and the Schröder government by being among the first countries that registered an excessive deficit.

The Franco-German couple will have a hard time complying with all these stipulations themselves, given that both register high public debt (in Germany estimated to go down from 83 percent in 2010 to 81 percent in 2012, in France rising from almost 82 percent to almost

[16] In the run-up to monetary union, the government asked the Bundesbank to engage in a favourable revaluation of German gold reserves but both Bundesbank and Eurostat rejected the attempt a creative accounting (Savage 2005: 125).

87 percent), while France has a stubborn fiscal deficit (7 percent in 2010 and just under 6 percent in 2011).[17] Obviously, their vigorous endorsement of a reform agenda that requires drastic adjustment in fiscal policies is not credible in the sense of upholding themselves as shining examples for others to follow.

To conclude this section, we do not find any evidence for stabilizing hegemonic rule emerging in the EU. To begin with, France and Germany are known to have different preferences and their agreements are therefore fragile. Moreover, even if they agreed more robustly, they do not have the necessary means at their disposal, in particular to provide solvency support to other Euro area governments. Finally, their approach to adjustment to deal with destabilising imbalances is a stark display of self-interest. The reforms initiated by the two countries support a framing of the Euro area crisis as a sovereign debt calamity even though it is public knowledge that it is primarily a European banking crisis, with French and German banks in the eye of the storm. Thus, their strategy is perceived as duplicitous and hypocritical. This undermines any gains in goodwill and in the authority of a potential hegemon that their enormous commitment of resources to the EFSF should have generated.

Conclusion: Political integration without fiscal integration?

Our contribution started with the puzzle of why the assisted stabilization of two member states of the EU, Hungary and Greece, had such different outcomes. We used the theory of hegemonic stability, as originated by Kindleberger (1973), as a lens to shed light on the comparison and on the longer term evolution of fiscal surveillance of Greece. These two case studies established that, first of all, there are subtle but important differences between an IMF

[17] Data from the AMECO database at URL: http://ec.europa.eu/economy_finance/ameco/user/serie/SelectSerie.cfm

stand-by agreement and an EU-dominated adjustment program, in terms of methodology of surveillance such as indicators used and in terms of the conditions imposed. To put it simply, the IMF wants a country to get back on track and contents itself with the repayment of the loan as the indicator of a successful technocratic fix. The EU, by contrast, tries to engender a revolution from above and considers only deep institutional changes that are likely to prevent further such difficulties as a sign of mission accomplished. The EU tried this revolution on Hungary, but, when the government there stopped cooperating and abandoned the adjustment program, the country was simply left alone. This is not possible for Greece. To us, this is a first indicator of the political integration that inadvertently comes with monetary union. This conjecture is also our explanation for the empirical puzzle why Hungary's loan program was so much less contentious than that of Greece.

Then we had a closer look at the driving forces behind the EU's thrust, France and Germany, the two members that contribute the bulk of funds for the new emergency facility, to see how their leadership in managing the euro area crisis evolved. The lens of hegemonic stability theory suggests that the Franco-German leadership is too weak to provide stability and the extensive use of conditionality is one symptom of this weakness. Above all, the two governments have failed to establish the authority that would make other members accept their hegemonic rule; fighting this crisis as a sovereign debt crisis is too obviously convenient for two administrations that prefer piling the adjustment burden on debtor countries rather than recapitalising their banks. Moreover, even if the two governments would show more willingness to provide the public goods required for international monetary stability, we found their ability lacking. In line with the interpretation of IMF conditionality in Gould (2006) and Stone (2002), we can thus understand EU conditionality as a way of reassuring financial markets when power is weak and selfish.

One political reason for weak leadership is that the two are too much engaged in a battle-of-the-sexes type game, that is to say they reveal profoundly different preferences and their laborious compromises can point in very different directions, depending on which side prevails. They differ on the desirability of European-level economic government in general, and on the policy of the ECB in particular. The French would like to see the ECB more clearly committed to its lender-of-last-resort role; Germany has reservations based on a long-standing belief in the separation of monetary and fiscal authority as a guarantor of monetary soundness. The division between the governments gives autonomy to the ECB, but also prevents this autonomy from being decisive: the lack of fiscal back-up forces the Bank to protect its balance sheet. As Kindleberger (2000: 216) said of the role of lender of last resort: 'Amounts agreed in advance are almost certain to be too little, and they tip the hand of the authorities to the speculators.' The lender of last resort has to face down the markets with an unlimited commitment, and this the ECB has not been prepared to do.[18] Its reservations have contributed to episodes of financial panic, while the division between France and Germany politicizes its stance.

Finally, as regards the support for adjustment, the institutions of economic governance have inherited a disciplinarian streak from the SGP. They are all about surveillance and shaming in peer review but not about sharing fiscal resources or imposing symmetrical obligations in macroeconomic management on surplus states. Attempts after the 2005 reforms of the fiscal framework, to use fiscal surveillance for low-key regulatory modernisation and transformation, have arguably been exploited by the Greek authorities. This has strengthened those forces who believe in pecuniary sanctions as a way of making semi-sovereign states

[18] We are inclined to turn around De Grauwe's apt phrase about the 'power without responsibility' of the ECB in normal times (De Grauwe 2005) and argue that during this crisis, the Bank had responsibility without the power that comes from fiscal backing.

comply. The support for adjustment is therefore above all political, namely lending support to a government under pressure to tell its electorate that 'There Is No Alternative'.

We are sceptical that this approach of political integration through dominance can work. Our conclusion resonates with Eichengreen's historical findings that a hegemonic stability can only be provided by a very strong leader in terms of economic capacity and political authority (Eichengreen 1987). The Franco-German couple has too little of either. Their actions create the impression of dominance, a regime which tends to be unstable because it is not bound by self-interested loyalty but by threat and a lack of alternative. Most importantly in the present context, it confronts governments in the secondary countries with a dilemma, namely making supranational cooperation impossible to reconcile with democratic decision-making at home. A disciplinarian and punitive thrust of EU economic governance makes this tension more visible because it turns the request for cooperation into an imperative of compliance. Even the well-meaning prescription of combining austerity with progressive redistribution to the poor is not helpful for governments under such pressure but makes them look careless and incompetent. The reforms of economic governance and, in its most extreme form, EU conditionality leave governments merely the unenviable choice between losing face with the EU and losing face with domestic constituencies. Hungary stands for choosing the former and become a pariah; Greece stands so far for the latter, but only because the ruling elites fear financial meltdown at present more than a backlash in the next election. Providing incentives for cooperation 'after hegemony' (Keohane) is the unresolved issue troubling the monetary union.

Is there an alternative? We can see first of all that political integration is a *fait accompli* of monetary union. In the very first test, financial markets ensured that the no bail-out clause became dead letter. Contrary to the standard account, political integration has preceded fiscal

integration. An element of fiscal integration is hot on the heels of the bailout process: the creation of the EFSF acknowledges that a unified monetary policy needs some backing from fiscal authorities. The bonds issued by the emergency fund are already Eurobonds in all but name. But a further shift in EU economic governance has to accompany this move, namely the recognition that it is not always delinquent fiscal authorities that get a country into trouble. The principal problem facing EMU is not the Greek budget, but capricious and pro-cyclical financial market movements. Members could collectively insure each other against these movements, but this will involve a joint and notionally open-ended responsibility for the sustainable share of public debt (De Grauwe and Moesen 2009, Mabbett and Schelkle 2010). The monetary union remains vulnerable as long as its dominant members refuse to acknowledge that markets perceive monetary union to be already politically more integrated than its lack of fiscal integration suggests.

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