

*Hubert Gabrisch**

A MACROECONOMIST'S VIEW ON EU GOVERNANCE REFORM: WHY AND HOW TO ESTABLISH POLICY COORDINATION?

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ABSTRACT: *This paper discusses the need for macroeconomic policy coordination in the E(M)U. Coordination of national policies with cross-border effects does not exist at the macroeconomic level, although requested by the EU Treaty. The need for coordination stems from current account imbalances, which origin in market-induced capital flows, destabilizing the real exchange rates between low and high wage countries. The recent attempts of the Commission and the European Council to reform E(M)U governance do not address this problem and thus remain incapable to protect*

against future instability. Macroeconomic coordination needs (i) a clear identification of union-wide employment goals, and (ii) the establishment of a high level institution responsible for coordination following these objectives. The paper proposes a High Representative for Economic Policy, equipped with an appropriate office and supported by a Council of Economic Advisers committed to the union-wide objectives.

KEY WORDS: *current account imbalances, governance, policy coordination, European Union*

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* Halle Institute for Economic Research (IWH), Germany; gab@iwh-halle.de

1. MARKET-INDUCED CAPITAL FLOWS ARE RESPONSIBLE FOR EU-WIDE IMBALANCES

According to Article 121 of the EU Treaty on the Functioning of the EU, member states of the Union shall coordinate their economic policies within the Council of Ministers. There is no written exception, but in fact national fiscal or income policies with their spillovers on union-wide employment, inflation, or fiscal stability are not subject to coordination.¹ What Europe has seen in joint policy actions in 2010 and 2011 was ad hoc coordination forced by the mushrooming public debt crisis, first through the temporary European Financial Stabilisation Facility (EFSF) and the European Financial Stability Mechanism (EFSM) in May and October 2010, to be succeeded by the permanent European Stabilization Mechanism (ESM) for the bail-out of insolvent EMU governments from 2013 onwards. The focus in this paper is on recent attempts to overcome the basic deficiency in treaty realization, which is the lack of policy institutions, not for bailouts but for crisis prevention. Up until now these attempts exist as proposals such as the Commission's 2020 agenda (early 2010), its 'six pack' proposal for surveillance and imposition of an excessive imbalance procedure (late 2010), and the European Council's Euro-Plus Pact (March 2011).²

The paper tries to answer the question of whether the attempts at permanent crisis prevention have set the EU on the right track towards effective and regular macroeconomic policy coordination. I am going to judge the reforms from a macroeconomic perspective. This is distinct from the discussion dominated by the institutional economic perspective, which compares the transaction costs and benefits of various solutions but tends to disregard or to remain empirically inconclusive with respect to real economic costs like unemployment or inflation (for an overview see Grusevaja and Pusch, 2011; and as an example see Hodson, 2009).

The second section of this paper will argue that financial market-induced capital flows in a non-optimum currency area tend to revalue the real exchange rate of poor countries and cause external and internal imbalances. The evidence for this is provided in section 3, and is also distinct from approaches that explain imbalances as policy-induced (for example, Laski and Podkaminer (2011) blame the monetary policy of the ECB). Both my basic economic argument and the

1 Compared to micro reform attempts (social insurance, labour market institutions, education, etc.).

2 Also called Pact for Competitiveness and Pact for the Euro.

evidence provided call for regular coordination based on symmetric policy actions, targeted at common rather than national employment and stability objectives. Institutional perspectives complete the picture in section 4, which summarizes the deficiencies of the EU governance system, above all the Stability and Growth Pact (SGP) and the Excessive Deficit Procedure (EDP). I argue that their asymmetric approach deepens the imbalances between countries, and offers opportunities to national fiscal and income policies to reinforce the market-induced results by policy-induced real devaluation and forced revaluation. In section 5 the above-mentioned reform attempts are critically evaluated. Section 6 concludes and presents the proposal for the institution of a High Representative for Economic Policy, hopefully capable of overcoming the dead end in coordination.

2. THE HISTORY OF EUROPEAN MONETARY COOPERATION: FROM SYMMETRIC TO ASYMMETRIC ADJUSTMENT

The recent hot debate on reform of the E(M)U governance system among European politicians and economists has been induced by the sovereign debt crisis in the Euro area. The debt crisis itself arose from the banking and financial crisis when all EU governments were engaged in rescuing banks and collected less tax revenues due to a decline in economic activity. However, in countries like Greece, Spain, Portugal, Ireland, and Italy, the accumulation of high debt positions in the private sector in the ten-year pre-crisis period went hand in hand with persistent current account deficits and capital inflows, while the counterpart countries accumulated credit positions through current account surplus and capital exports. This balance-of-payments link brings us to the issue of competitiveness and the real exchange rate. Capital inflows, current account deficits, and increasing private and then public debt find their common origin in the deterioration of the real exchange rate, or in other words in a real revaluation in debtor countries and a corresponding devaluation in creditor countries.

The issue of establishing mechanisms effective in stabilizing real exchange rates is a well-known problem in a world with different currencies. The issue is closely related to the impact of capital flows on a country's competitiveness in goods markets, hence on current account positions, private debt, and employment in the global perspective. Countries with high inflation need a devaluation to restore their competitiveness in goods markets, while countries with low inflation need a revaluation. However, with free capital flows currency markets produce quite the opposite result. Higher interest rates in countries with relatively high inflation lure short-term capital inflows to draw gains from arbitrage, which

lead to an appreciation of the exchange rate, and vice versa. Hence the need for symmetric action of capital exporting and importing countries. The issue was hotly debated before and at the Bretton Woods conference in 1944. In 1942 Keynes had already proposed a clearing union when thinking about a new world economic order after the devastating experiences of the period between world wars. “The Clearing Union must also seek to discourage creditor countries from leaving unused large liquid balances which ought to be devoted to some positive purpose. For excessive credit balances necessarily create excessive debit balances for some other party. In recognizing that the creditor as well as the debtor may be responsible for a want of balance, the proposed institution would be breaking new ground”. (Horsefield, 1969: 20).

The Bretton Woods system of fixed exchange rates failed due to its ignoring destabilizing capital flows. Its Asian survivor (exchange rates pegged to the US dollar) followed, to collapse in the 1997 crises. Currency carry trades have been a well-known phenomenon since the early 1980s when financial institutions invested heavily in the Yen in Asian emerging markets, or recently when investors engaged short-term in Swiss Franc lending to Eastern European countries with flexible exchange rates (Gyntelberg and Remolona, 2007; Galata et al., 2007). The inflows of capital lead to a revaluation of flexible exchange in the high-inflation countries that is against the fundamentals, which demand devaluation. These experiences are the background to proposals to return to a global system of managed flexible exchange rates with symmetric interventions (‘re-alignments’) to ensure stable real exchange rates and sustainable current-account positions completed by effective macroeconomic coordination (see, for example, UNCTAD, 2009, p. 127; see also the US proposal for indicative guidelines at the G20 summit, November 2010).

With the European Monetary System (EMS) Europe returned to a system of managed exchange rate flexibility. Between 1979 and 1998 a change of the central parities in a bilateral relationship had to be agreed on a multilateral basis in a symmetric way: a simultaneous devaluation of one currency was completed by the revaluation of one or more other currencies.³ Hence, the burden to adjust was symmetrically distributed between the involved countries. Although fragile and needing frequent adjustments, the EMS was quite successful in stabilizing the real exchange rates. One of these adjustments, the Basle-Nyborg agreement of 1989, completed the EMS exchange rate mechanism with a closer monitoring of monetary developments in the participating countries. The introduction of the

³ Symmetry did not mean that the extent of both changes were the same.

common currency and the single monetary policy of the European Central Bank (ECB) substituted for symmetric adjustments and installed a fiscal monitoring with the asymmetric provisions of the Stability and Growth Pact (SGP) and the Excessive Deficit Procedure (EDP); only countries with excessive deficits had to adjust.

The single currency eliminates nominal exchange rate fluctuations but it fails to install a system of stable real exchange rates measured in terms of relative unit labour cost (ULC) or other terms.⁴ Arbitrage on short-term financial markets (money and currency markets) is no longer possible, but the deviation of real exchange rates from fundamentals like productivity evolves directly through the other financial markets, and thus the cause-effect relationship is different to a multi-currency system with flexible exchange rates: the trigger of instability is the erosion of risk premiums which allows for expropriating the specific benefits of countries with relatively low wage costs. Massive capital flows from countries with higher wage costs into low-cost countries contribute to higher inflation in the latter. Nominal upward wage adjustments follow higher inflation and lead to the de-coupling of productivity and wages and to an increase in relative ULC; this is the real appreciation effect for the low-cost country. Quite the opposite would be necessary to meet with fundamentals and to ensure competitiveness in goods markets: capital importing countries with low wage costs need devaluation while capital exporting countries with high wage costs need an appreciation of their real exchange rate. This wage convergence process must come to an end when wage levels are equalized; however, the process will collapse earlier when private debt becomes unsustainable – as well as the asset position of the lending country.

The erosion of risk premiums that makes the problem of stabilizing the real exchange rate in a currency union different from a multi-currency system is not only or even predominantly a result of the vanishing exchange rate risk. It is the result of ignorance of existing country-specific investment risks. The problem is known as ‘risk sharing’, which goes back to Mundell’s (1973) and MacKinnon’s (2006) contributions to the theory of optimum currency areas. The full stock of financial assets of lenders in a country A against a borrowing country B could be exercised as a claim on the resources of all the other countries, C, D, or E, should B be hit by a sudden decrease in output or a wage shock. Risk sharing was originally understood as distributing shocks more symmetrically among the

⁴ Other measures of real exchange rates exist; for example, the ratio between prices of tradable and non-tradable goods.

members of a currency union. Mundell (1973) judged the effect as strong enough to compensate for all traditional deficiencies of a currency union (divergences in structure, priorities, lack of labour mobility, etc.), which made him benevolent towards the common currency project in Europe. However, the distribution of Greek and other countries' risks after the crisis was a fiasco. Risk sharing supports moral hazard in the financial industry.

There is no market mechanism in a currency area to get the prices right. Even if the common currency and single monetary policy increase the demand for nominal wage flexibility and lead to a convergence of labour market institutions (the endogeneity argument; see Calmfors, 2001, p. 2), they do not prevent the emergence of real exchange rate instability. Assume that the typical national wage function with national inflation and productivity increase as variables in high-wage as well as low-wage countries: in the high-wage country capital outflows will suppress national inflation, nominal wages will follow the lower inflation path, and ULC will decline; while in the low-wage country with capital inflows ULC will increase due to higher inflation (we assume productivity increases in both countries as given). Hence, the need for wage adjustment is a symmetric one: nominal wages in high-wage countries need to be above and nominal wages in low-wage countries need to be below the inflation rate. This was the effect of the re-alignment procedure in the old EMS: the revaluation of the currency meant a relative increase of the labour costs in the surplus country, and vice versa. The symmetry argument becomes even more visible if national wage formation follows the average inflation rate of the currency area (or the inflation target of the central bank). Only, in this case, the stability of real exchange rates can be maintained, as well as the stability of the common currency. In the absence of the Balassa-Samuelson effect,⁵ national monetary conditions would converge.⁶

3. FACTS FOR THE EMU: INFLATION AND WAGE INCREASES FOLLOW CAPITAL INFLOWS

Is there sufficient evidence for this theory? Figure 1 illustrates the nominal compensation per employee⁷ in euros of the five countries with the lowest wage level (Greece, Portugal, Spain, Italy, and Ireland) compared to the unweighted

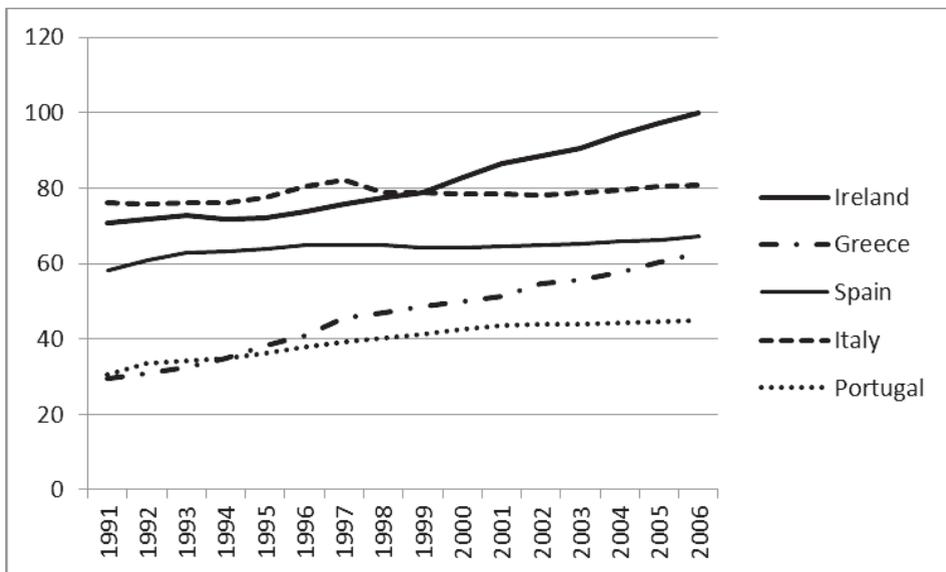
⁵ The effect seems to be weak (see Lommatzsch and Tober, 2006, also for an overview on the empirical literature for the EU).

⁶ This is the argumentation of the minority position in the German Council of Economic Advisers (Sachverständigenrat, (2005, p. 729).

⁷ The indicator includes social taxes and non-contractual wages.

average of the five high-wage countries (Austria, Belgium, Germany, France, the Netherlands). There is a very strong increase of nominal compensation in Greece and Ireland, and a less pronounced ‘convergence’ in the case of the other three countries. The decline of risk premiums is shown in Figure 2 in terms of the risk premium on ten-year sovereign bonds. We see a sharp decline for Greece, Italy, Ireland, Portugal, and Spain since the mid-1990s (Euro preparation stage) – all countries, except Italy, with relatively low wage costs at that time.

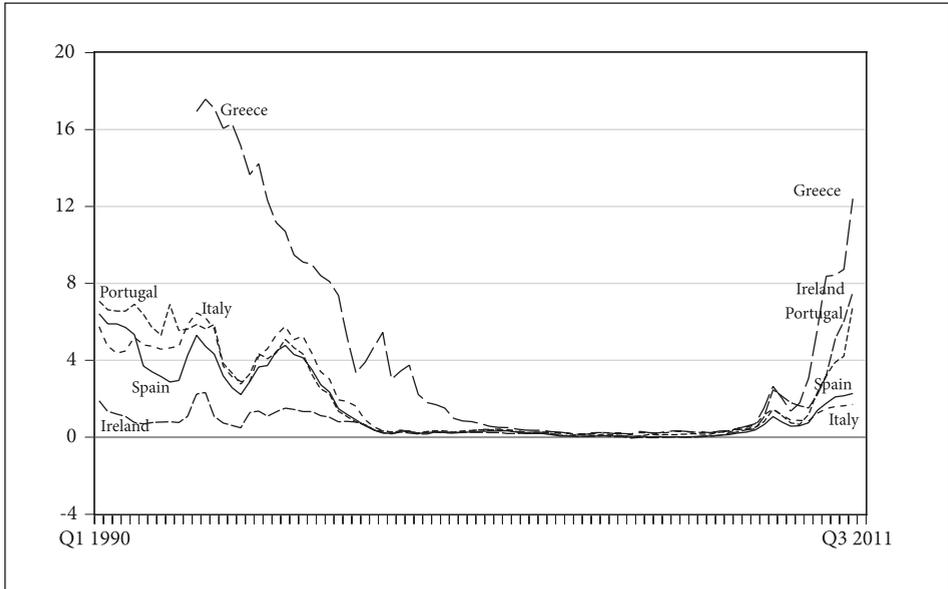
Figure 1: Wage differences - nominal compensation per employee in euros (unweighted average of 5 high-wage countries = 100)^a



^a Austria, Belgium, Germany, France, and the Netherlands.

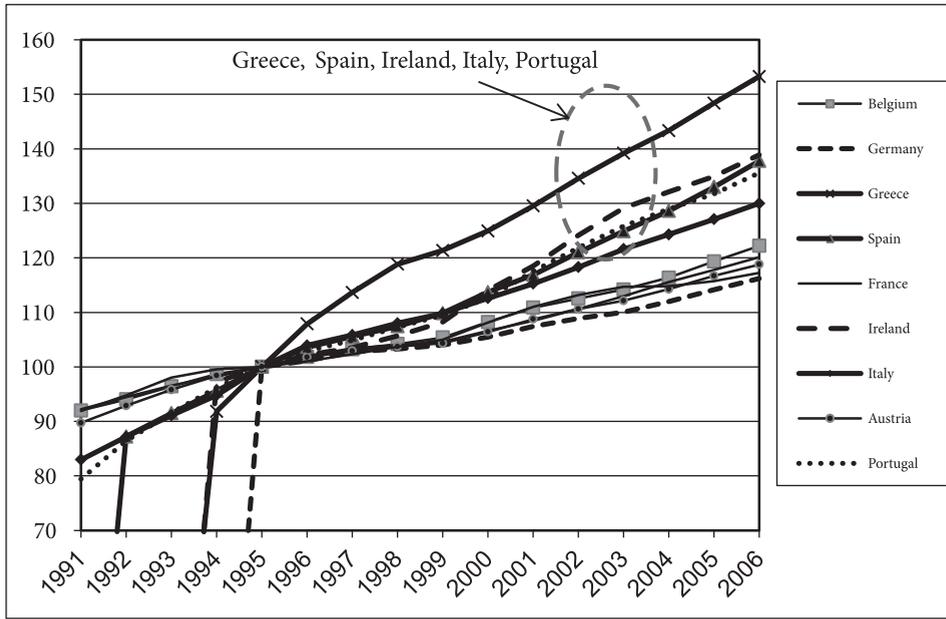
Source: European Commission Economic and Financial Affairs (2011), own calculation and presentation.

Figure 2: The decline of sovereign bond risk premium (government 10 year bond yields against German government bond yields) for Greece, Portugal, Spain, Ireland, and Italy, 1990 - 2011



Source: IMF, 2011.

Figure 3 depicts the widening differences in price levels in terms of cumulated differences in the Harmonized Consumer Price Index (HCPI). Greece, Spain, Portugal, Ireland, and Italy belong to the countries with the highest levels accumulated over time, while Germany, Finland, Austria, and France report the lowest levels.

Figure 3: HCPI^a (1995=100) of selected Euro area members

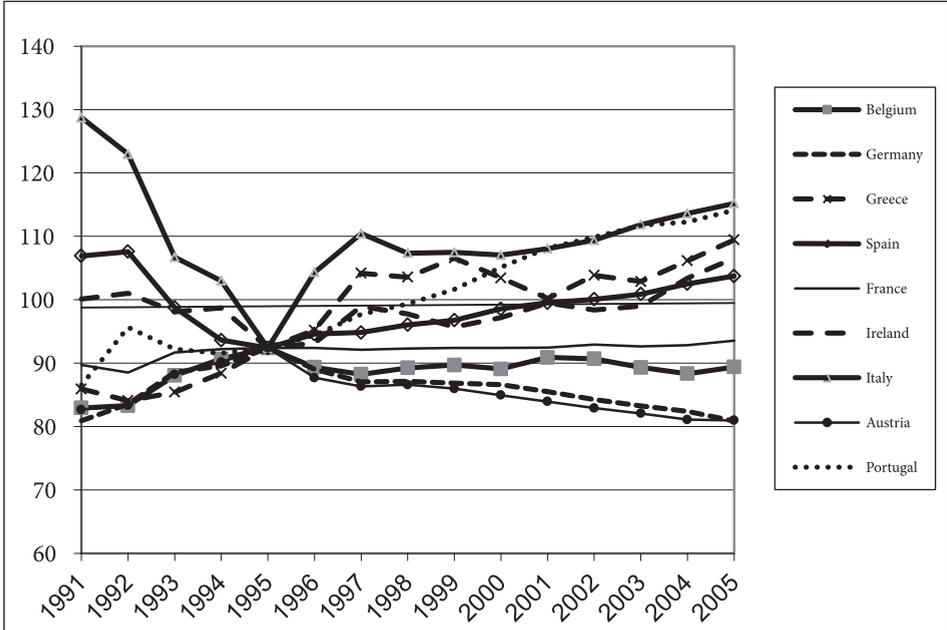
^a Harmonised Consumer Price Index.

Sources: European Commission Economic and Financial Affairs (2011), author's calculations.

In Figure 4 the index of unit labour costs illustrates that Germany, Austria, and Finland show a path below the euro area average, while southern members (plus Ireland) are above (for a similar picture, see European Commission, 2004). If, for example, wages in Germany had followed the average E(M)U inflation rate instead of the lower rate, German ULC would not have deviated so much from the average ULC in the EU.

A test of Granger causality with stacked data for E(M)U member countries reveals that inflation determines wage costs rather than vice versa (Table 1). This causality is in line with the theory of monetary integration where regional inflation pressure can be caused only by relatively high capital imports, while in an economy with its own currency wage increases over productivity induce inflation if the central bank or the domestic banking sector accommodates.

Figure 4: Unit labour cost^a index (1995 = 100) of the euro area members, relative to the weighted average



^a Nominal compensation per employee to real GDP per employed person

Sources: European Commission Economic and Financial Affairs (2011), author's calculations.

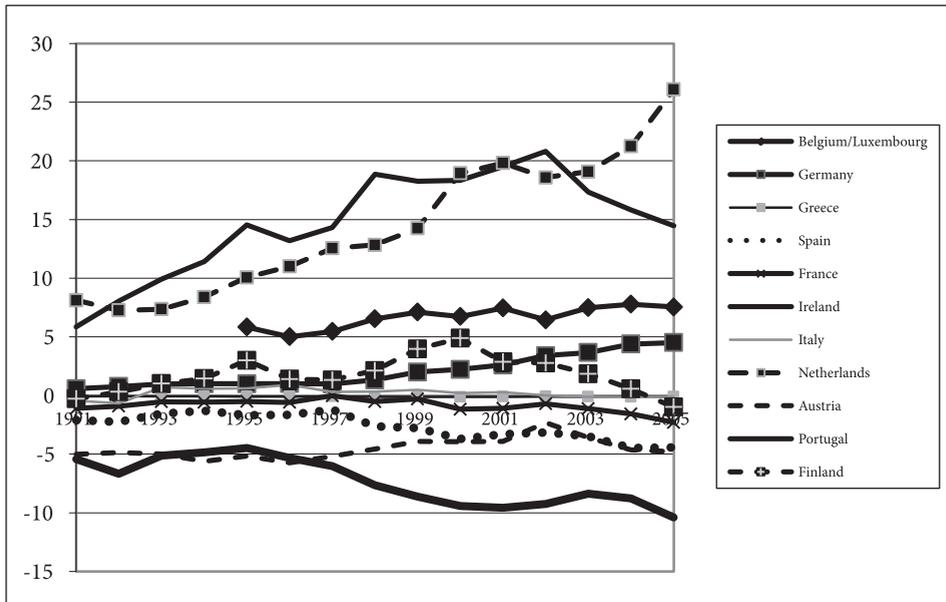
Table 1: Pairwise Granger Causality Tests for stacked EMU member countries

Sample: 1991 2006			
Lags: 2; obs.: 240			
Null Hypothesis:	Obs	F-Statistic	Prob.
ULC does not Granger Cause inflation	165	1.78470	0.1712
Inflation does not Granger Cause ULC		10.9237	4.E-05

ULC: annual rate of change of unit labour cost; inflation: annual rate of change of the HCPI.

Figure 5 illustrates the history of trade imbalances. Countries with eroding risk premiums, higher inflation, and wage cost increases show growing trade deficits, while countries with traditionally low risk premiums, lower inflation, and wage cost increases below average show growing trade surpluses.

Figure 5: Intra-EU net exports in % of GDP, 1991 - 2005



Sources: European Commission Economic and Financial Affairs (2011), author's calculations.

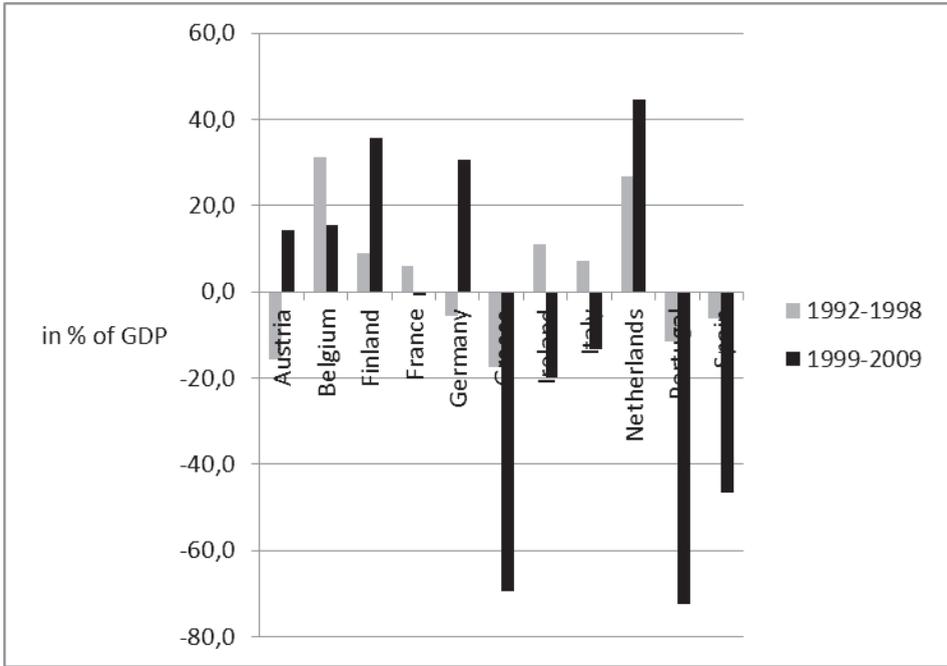
Figure 6 shows the cumulated current account position as a proxy for debt and credit positions among EMU countries. There are remarkable shifts in these positions quite opposite to the predictions of the inter-temporal balancing hypothesis.

Finally, in Figure 7 we see that those countries with still sustainable budget positions in 2006, such as Spain, Ireland (surplus), and Italy and Portugal (meeting the 3% deficit criterion of the SGP) run the highest deficits in 2009. This is the effect of the private debt crisis, when governments bailed out their national banking systems.⁸ This shifted the attention of political leaders and economists from the financial to the fiscal sector: the issue of fiscal inappropriateness

⁸ Not to forget the effects of the automatic stabilizers and discretionary measures to stabilize effective demand.

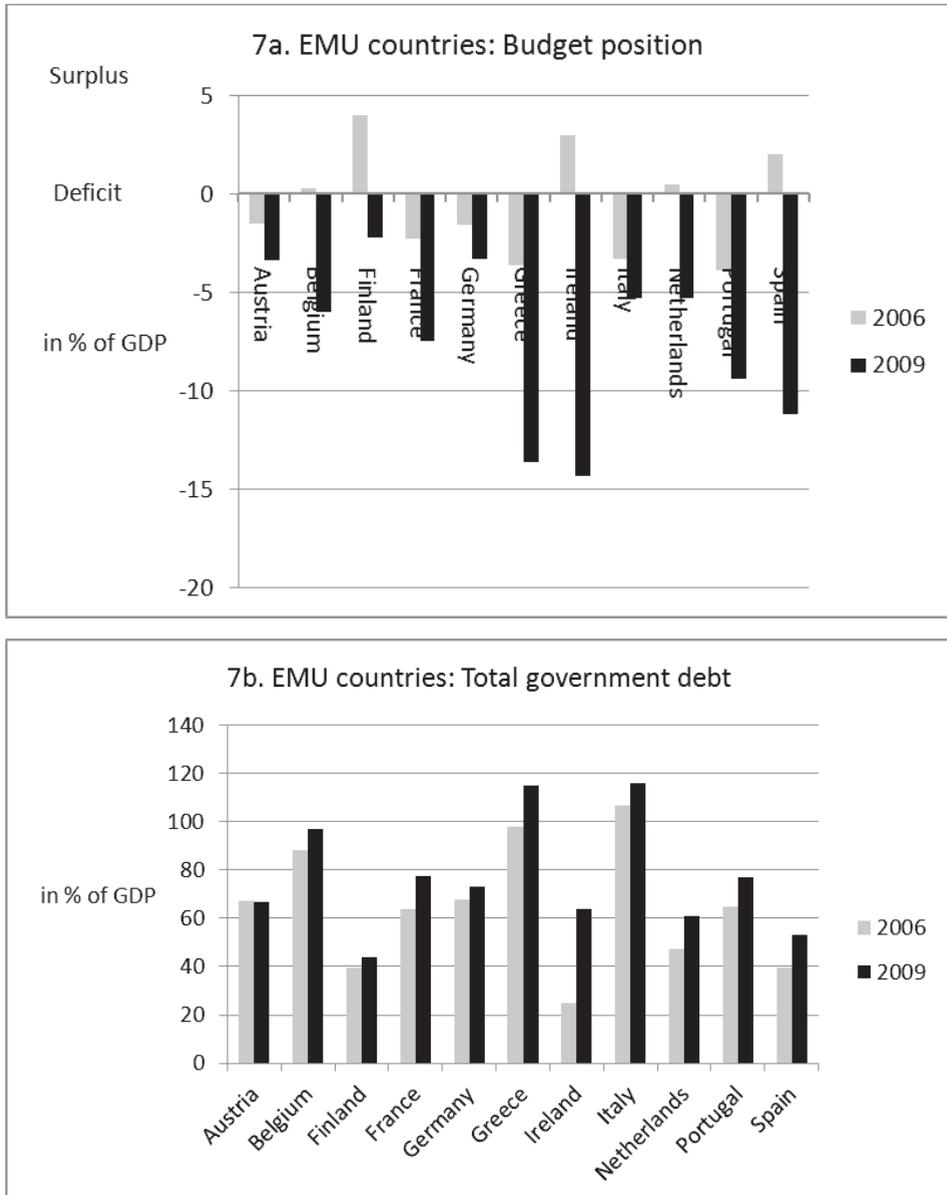
replaced the issue of financial sector inappropriateness following destabilizing capital flows.

Figure 6: Cumulated Current Account (CCA) Positions of EMU countries, in % of GDP, 1998 and 2009



Source: OECD, 2011.

Figure 7: EMU countries: Change in public positions



Source: OECD, 2011.

4. THE EU GOVERNANCE SYSTEM FOSTERS THE NATIONAL PERSPECTIVE

Under the assumption that the currency union would work like an engine for structural, institutional, and macroeconomic convergence, the transition from the EMS to the Euro system abolished any symmetric adjustment mechanism. However expectations that labour markets would take over the function of the nominal exchange rate were not fulfilled (Buscher and Gabrisch, 2010). Rather, cross-border capital flows de-coupled nominal wages from productivity. Moreover there is no coordinated fiscal and income policy committed to union-wide full employment: full employment was and is seen as the result of labour market reforms at the national level, for which the single currency and common monetary policy should be the driving forces. Nor was effective macroeconomic coordination with a clear focus on union-wide employment implemented, although articles 119-121 of the treaty on the functioning of the EU clearly stipulate that the economic policy of member states is subject to “close coordination” and has to be a matter of common interest. Fiscal or income/wage policies are not explicitly excluded, but in fact national governments have undertaken many fiscal actions that impact on wages and income without consultation at the EU level. One criticized attempt at achieving a highly competitive position is the German policy of wage moderation (De Grauwe, 2006).

After the introduction of the common currency and the single monetary policy, monetary monitoring (Basle-Nyborg treaty) was replaced by the monitoring of fiscal developments together with the provisions of the Stability and Growth Pact and the Excessive Deficit Procedure. The solution to the basic problems of the currency union, namely unstable real exchange rates and weak growth and unemployment at the union level, was not addressed.

The discussion among leading European economists about the short-comings of the SGP and EDP circles around their effectiveness; the problem of real permanent real exchange rate changes is disregarded. The governance system suffers from asymmetric information between the monitoring authority and the individual government (Pisany-Ferry, 2010), leading to moral hazard of the latter (Hodson, 2009). Greece is the striking example of failures in the EU statistical reporting system. There is an enforcement problem, which the principal-agent perspective so nicely reveals: the government as the agent is part of the body of the principal – the Council of Ministers. If agents slip into the role of their principal, enforcement becomes a joke: sanctions against the most powerful members (Germany, France) might not be undertaken. As Buitier (2006, p. 699) observed, the “SGP has made a contribution to sustainability only in EU members desiring

to become full members of the EMU”. Fulfilling the Maastricht convergence and stability criteria prior to EMU accession does not necessarily mean fulfilling them later (Gabrisch and Orłowski, 2010). But Buiter (2006, p. 698) raises a more important argument in favor of policy coordination: the SGP influences and constrains each individual country’s fiscal policy without any reference to economic conditions in other countries. Without any coordination mechanisms fiscal actions might strengthen the change in the competitive positions induced by capital flows. Countries that should revalue their real exchange rate against other members of the E(M)U can actually improve their competitive position by fiscal action. A striking example is the 2007 hike in the German value added tax by 3 percentage points, which increased the prices of imports to Germany and worked like a devaluation of the real exchange rate.

5. AN ATTEMPT AT EFFECTIVE REFORM? EURO PLUS AND THE EXCESSIVE IMBALANCE PROCEDURE

With negative spillovers of fiscal actions in the non-optimum currency area without fiscal transfers, effective⁹ macroeconomic policy coordination is not only a necessity but required by the EU treaty. Although the problem of unsustainable current account deficits had been discussed among economists before the outbreak of the crisis in 2009 (see among others the tests for sustainability by Fischer, 2007, and Dullien and Fritzsche, 2007, or Aherne et al, 2007 in connection with capital flows from high to low income countries), it was the outbreak of the crisis that put the issue back on the political agenda.¹⁰ In March 2010 the EU Commission published its Europe 2020 strategy, which is the successor to the Lisbon agenda for 2010. The Commission argued that policy coordination in the EU was successful in limiting the negative impacts of the financial crisis on the real economy (European Commission, 2010a: 9), but a closer political coordination would be necessary to counter the destabilizing imbalances and differences in competitiveness (p. 31). The Commission proposed a system of annual surveillance (“European Semester”), including not only the fiscal stances but also other important macroeconomic indicators such as external positions. However wage formation was not included, although nominal wages deviated from productivity growth in almost all countries – either in one or the other

⁹ The term ‘effective’ serves to distinguish attempts from weak modes of coordination, like the open method of coordination (OMC) in employment and other policies that are based on ‘naming and shaming’ pressure.

¹⁰ It was a big topic prior to EMU in the 1990s; coordination or policy rules. See Pisano-Ferry, 2006. The author already draws the lines in a pre-crisis debate on EU governance issues.

direction. In September 2010 the Commission proposed six decrees (“Six pack”) to be passed by the European Parliament and the European Council in 2011 to improve economic governance (European Commission, 2010b). In one of these proposals (European Commission, 2010c) the Commission suggests extending surveillance of economic policies beyond budgetary surveillance (in the EDP) and the introduction of an Excessive Imbalance Procedure (EIP), including a fine as the enforcement mechanism. Surveillance would be based on a scoreboard of indicators, of which some would have a symmetric character including not only unsustainable deficits but also permanent surpluses if too high. This is certainly different to the SGP, where only a budgetary deficit (and public debt) is considered.¹¹ However the approach suffers from severe analytical shortcomings. Firstly, a symmetric approach to current account imbalances contradicts the asymmetric approach in the existing SGP and EDP, since both invite competitive fiscal policies which deepen trade imbalances. Secondly, the first view progress towards more symmetry is strongly diluted by ignorance about the effects of cross-border financial investment; we read (p. 4) that “A current account deficit of 3 % may be considered acceptable in a converging country with strong investment needs, but not in a more advanced country with a rapidly ageing population”. There is neither striking evidence nor theoretical reasoning that convergence is possible only with current account deficits or capital imports.

At its meeting in March 2011 the European Council set a clear counterpoint to the halfhearted attempts of the Commission (European Council, 2011), although maintaining the usual Brussels declaration approach by formally accepting all former papers and proposals of the Commission. But the Euro Plus Pact of the Council intends to preserve the competitive approach to wage and fiscal policies. At first glance the pact acknowledges, correctly, that wage increases should occur in line with productivity progress (p. 16). However in the same breath it states, on ULC, “Large and sustained increases may lead to the erosion of competitiveness, especially if combined with a widening current account deficit and declining market shares for exports”. So far only an upward and not a downward deviation of wage increases from productivity is seen as a problem. Hence, the burden for adjustment is put on the deficit country, as before. As long as Europe’s leading politicians do not acknowledge that the origins of current account imbalances are symmetric, no effective progress in stabilizing the E(M)U can be expected. The Euro Plus pact defends the competitive wage policies of some richer EU countries, among them some that contributed to emerging current account

¹¹ In fact the public debt indicator lost its relevance at the very beginning of the monetary union.

imbalances. Moreover the Pact clearly repeats the old and dubious position that unemployment is made on labour markets (p. 17), ignoring its macroeconomic origins. Clearly, inflexible labour markets, not financial markets, are posited as the drivers for current account imbalances. Insomuch, employment should be increased by labour market reforms and lower taxes on labour – an approach the value added tax hike in Germany 2007 would fit perfectly. Finally, the Council confirms the role of the existing SGP/EDP asymmetric framework and ignores that – in the words of Buiter (2006: 698) – the pact does not “take account of any other past, current and anticipated future economic developments in the E(M)U area as a whole.”

6. CONCLUSIONS, AND A PROPOSAL

We have to conclude that the European Council’s latest decisions will not provide any effective contribution to overcoming the sovereign debt crisis; nor will it protect against future macroeconomic instability. Rather the danger is that an inflated macroeconomic reporting system will create a new bureaucracy, stripped of any real influence but poring over mountains of documents. What Europe needs is a new (contractual) complex of economic policy cooperation that couples transparency with the priority of European over national perspectives. National economic policies need to include the perspective of employment and financial stability in other countries. More effectiveness means coordination in the framework of cooperation reaching far beyond the usual ‘naming and shaming’ effects on the operative level, as in the open method of coordination. In fact the EU has already created a model for such a system in a field where nations are in part inclined to defend sovereignty: foreign and security policies. Indeed, European policy makers believe more in high-ranked coordination in the less integrated third pillar of the EU than in the mostly integrated first pillar. The installation of a High Representative would be a model for more cooperation without formally reducing national sovereignty in economic policy. A High Representative would be a high-ranking institution in the EU pecking order, and would function as an interface between the Commission and the European Council. In so doing, it would gain sufficient democratic legitimacy for coordinated policy action. As in foreign and security policy, the High Representative should be equipped with an office for ex-post and ex-ante monitoring and surveillance. The assessment of the macroeconomic situation of the entire EU region should be left to an independent Council of Economic Advisers, whose opinions and recommendations with respect to wage and fiscal policies would create the grounds for the High Representative’s coordination attempts. In such an approach sanctions would be

symmetric and not asymmetric, as in the reform proposals recently discussed. Such a reform would contribute to making article 121 of the EU Treaty on the Functioning of the European Union more binding: “Member States shall regard their economic policies as a matter of common concern and shall coordinate them within the Council (...)”.

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