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Article (Accepted version)
(Refereed)

Original citation:
Bongardt, Annette and Torres, Francisco (2016) *EMU reform and resilience in a re-dimensioned EU.* Politica Economica, 32 (3). pp. 575-595. ISSN 1120-9496

DOI: 10.1429/85012

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Available in LSE Research Online: January 2017

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EMU Reform and Resilience in a Re-Dimensioned EU[1]

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ABSTRACT: Although significant progress has been made in various areas since the eruption of the financial and sovereign debt crises, EMU governance is still incomplete today. The incompleteness of EMU governance, notably in its economic sphere, leaves EMU vulnerable to adverse market and to political-economy pressures. This paper argues that the possible EU exit of the UK, which had negotiated an opt-out from the common currency already at Maastricht, may allow for more homogeneous preferences regarding the additional requirements on the economic union as to sustain monetary union. To that end it could facilitate decision-making and contribute to the completion of the governance of EMU, whose relevance as the core of the EU integration project Brexit has come to reinforce. The resilience of the Eurozone however continues to hinge importantly on the creation of adjustment capacity and ownership of reform at the member state level, for which it is important to have a cohesive approach to the completion of EMU and a less negative narrative on EU integration at the domestic levels.

KEYWORDS: Brexit, Institutional Reform, EU economic governance, EMU resilience and sustainability

JEL classification: E42, E61, E65.

1. Introduction

To be sustainable, the EU will need to focus and deliver on the EU common goods. The same holds true for the EU's Economic and Monetary Union (EMU), which has emerged as the core of the EU integration project, arguably even more so since the June 2016 Brexit vote that set a precedent for a future re-dimensioned EU club.

However, despite efforts towards a 'Genuine' Economic and Monetary Union (GEMU), EMU's governance framework has remained incomplete in the economic union

[1] An earlier version of this paper was presented at a Conference in Honour of Mike Artis, organised by the EUI Economics Department in Florence, 17 June 2016. We would like to thank Paul De Grauwe, Charles Goodhardt and Ramon Marimon, for valuable comments and discussions.

sphere, leaving EMU vulnerable to adverse market and also to political-economy pressures. This article investigates the challenges for EMU reform and resilience within the context of a re-dimensioned EU club.

The remainder of this paper is organised as follows. The ensuing section shows how too much differentiation – exemplified by the UK's permanent opt-out from *cum* opposition to completing EMU – does not allow EMU to deliver. Section 3 explains how EMU's incompleteness allowed for the building up of macroeconomic imbalances throughout its first decade. Section 4 examines how the crisis brought additional demands on the economic union part of an incomplete EMU to the forefront and discusses institutional reform proposals made under the heading of a 'Genuine' EMU. Section 5 focuses on the importance of structural reforms for EMU resilience and sustainable growth. Section 6 broadens to the comparative political economy literature, beyond OCA theory, discussing what kind, timing and mix of national reforms would be required to make a currency union like the Eurozone deliver. Section 7 concludes.

2. Brexit and beyond: The need for a more homogeneous EU club for EMU to function

If there is one fundamental lesson to be learned from the June 2016 vote on the UK's exit from the EU (Brexit), it is that the EU will need to focus and deliver on EU common goods in order to be sustainable (Bongardt and Torres, 2016b). The UK's announced exit from the union marks a qualitative change in the nature of EU membership. It testifies to the challenges facing an EU club that has, over the years, not only experienced a significant increase in membership and hence size but by many accounts also in heterogeneity. In the process it has been confronted and needs to come to grips with divergent member state preferences on issues as diverse as regulation and institutions; if substantial, those may erode the basis for trust-based decision-making that stems from similar preferences (on which for instance the principle of mutual recognition relies). Individual countries may of course opt to trade off benefits across issue areas and various common goods, which may facilitate compromises. The EU club risks putting its decision-making and problem-solving capacity – and thereby its output legitimacy – at stake, to the extent that its governance becomes inadequate and does not evolve as to

enable institutions to function properly and to deliver on club benefits.[2]

The Brexit vote has highlighted that successive enlargements brought countries with divergent views on European economic integration into the club. The European Economic Community (EEC) had started out with rather homogeneous preferences for a profound economic and political integration project and for supranational governance, whereas those countries joining at later points in time had started out with less ambitious economic integration preferences.[3]

Reaching consensus on the completion of EMU governance has become more complicated in light of a combination of rising EU membership and more heterogeneous member states, aggravated by the fact that the Eurozone – where interdependencies are larger and the completion of EMU governance is more urgent – does not comprise all members of the EU club. It is illustrative that the Eurozone risked seeing its legitimate efforts to strengthen EMU, including where necessary by deepening the single market, to be vetoed by the UK (Sapir and Wolff, 2016; Bongardt, 2016).

In the EU, heterogeneity has given rise to differentiated integration. In the face of divergent interests across member states, differentiation, through opt-outs and reinforced cooperation, seems to offer a way out (Spolaore, 2016; Koenig, 2015). In fact, most of the EU's core policy areas underwent some form of differentiation since the 1990s. For Koenig, EMU is a classical example of a two-speed Europe. In the Eurozone, new forms of differentiation have made an appearance in recent years, taking place within and outside the EU's legal and institutional framework. The resulting intergovernmentalisation of EMU could of course be merely a temporary phenomenon if the adopted measures were to be later incorporated in the EU treaties.[4]

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[2] According to the economic theory of clubs, there is an optimum size of the club in function of club benefits and heterogeneity costs (i.e., at the margin benefits are just equal to heterogeneity costs).

[3] Successive enlargements to former EFTA, COMECON and other countries raised membership of the club from initially 6 to currently 28 member states. Since the Maastricht treaty, the EU aims at Economic and Monetary Union in terms of economic integration level. The Eurozone, a sub-club to the EU (from which the UK and Denmark had negotiated an opt-out to joining the common currency at Maastricht), also enlarged its membership from initially 11 to presently 19 member states. It has *de facto* established itself as the core of European integration (since the Maastricht treaty, the EU aims at Economic and Monetary Union).

[4] The UK, opposed to integration in the Community framework, had asked for a clarification of this point; it was made redundant by Brexit.

The UK, a non-Eurozone member, not only stayed at the margin of economic governance advances but it also came to veto economic governance advances within the EU's legal framework and hence contributed to the intergovernmentalisation of EMU governance. As a consequence, the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG), also known as as the Fiscal Compact, could only be signed as an intergovernmental treaty outside the EU legal framework. The regulatory area under the control of the ECB also remained smaller than the single market in financial services (which has been to the benefit of the UK).[5]

One may therefore conclude that differentiation through opt-outs and reinforced cooperation can only work in other not so central remits of European integration and possibly only in the short term since too much differentiation puts the cohesiveness of the EU project at stake.

From the point of view of the EU club, the UK's non-participation in many European common goods meant that benefits from UK membership were also more limited while the UK's blocking of decisions at the EU level raised the costs associated with its membership. As far as EMU is concerned, with the Eurozone having established itself as the *de facto* core of European (political) integration, the UK's preference for a stand-alone (and incomplete) economic union became untenable. It conflicted with the need to make the monetary union work, which requires further integration and institution building in the economic union sphere. The UK did not want to participate in the completion of economic union through the various intergovernmental arrangements aimed at strengthening economic governance nor by means of constructively assisting any of the member states whose economies underwent adjustment (bailout) programmes.[6] Besides having opted out of EMU, the UK does not participate in the Euro-plus Pact, the Fiscal Compact (having obliged all the other member states to resort to an

[5] Thanks to privileged access UK banks benefited from the European Central Bank's (ECB) liquidity operations during the global financial crisis. The regulation and oversight of central counterparties (CCPs) – presently done jointly by the ECB and the Bank of England – means that there is a high proportion of euro-denominated financial activities, from which the City of London benefits (Haan et al., 2016).

[6] This manifested lack of solidarity also conditions the capacity of response, both in terms of EU-level institutional reform and structural reforms at the national level.

intergovernmental arrangement in the first place) and in the European Banking Union.[7]

Brexit has the potential to turn the EU more homogeneous in terms of preferences and allow EMU to function better by some accounts. For instance, the departure of the UK opens up the perspective that financial regulation in the single market can be better geared towards the Eurozone's public good of financial stability, thereby reinforcing the economic union in a crucial area for the monetary union. Without UK opposition it might also prove easier to bring intergovernmental economic agreements within the Community framework at some stage.

Moreover, the fact that Brexit opened the door for any discontent EU member state (whether actual or potential EMU members or EU members with an opt out from monetary union) to exit the club ought to reduce any member state's capacity to hold up decisions that are in the common interest, and to that extent can be expected to facilitate decision-making and problem solving.

EMU is not only an economic but also (if not above all) a political project that has triggered and still requires further integration. Making monetary union work requires completing the economic union so that it can sustain the single currency and delivering on the EU's wider objectives.[8] The single market can therefore not be seen as static. Rather, it is in the legitimate interest of present and future Eurozone members – all EU members except the UK and Denmark, which have an opt-out since Maastricht, although Denmark shadows the Eurozone – that it be deepened with regard to Eurozone requirements, as to make the monetary union function well and indeed render it sustainable in light of the increased interdependencies between its members. This requires advances on institutional modernization and structural reform in the face of globalization. The issue is obviously important for the sustainability of the monetary union, but goes beyond and right to the heart of the EU project. To be sustainable, the EU needs to complete Economic and Monetary Union and make it deliver economic and

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[7] See Sapir and Wolff (2016) for an illustrative graphical representation. At present only six countries participate in all main EU institutions and reinforced cooperation sub-clubs, namely Austria, Belgium, France, Germany, Portugal and Slovenia. The UK stands out as the least integrated of all member states, followed by the Czech Republic, Sweden, Denmark, Poland and Hungary (Koenig, 2015).

[8] As for instance recognized by the Eurosystem with respect to the objectives of the Europe 2020 strategy (European Commission, 2010).

social results. Member states should then be prepared either to contribute to those aims or to seek alternative ways to follow different and non-compatible preferences, be it in the EEA or in free trade or association agreements with the EU.

3. EMU's incompleteness and the building up of macroeconomic imbalances

While academics had called attention for EMU's incompleteness from the start (Giavazzi and Wyplosz, 2016), policy makers and politicians from member states only managed to agree on monetary union as the lowest common denominator, hoping for preferences to converge in the economic union part of EMU.[9] The result was that coordination in the economic union assumed the character of an open compromise, where posterior governance advances were left conditional upon sufficient preference convergence to occur (Torres 2009). Questions left open primarily concerned how to enforce the convergence/stability (entry) criteria once countries had joined EMU and how to further coordinate budgetary and various other policies in order to guarantee EMU's sustainability.

The fiscal (entry) criteria were complemented in 1997 by the establishment of the Stability and Growth Pact (SGP) with regard to the post-entry period. They did however not address institutional and economic gaps in the criteria identified by some economists for an optimum currency area (OCA); still, endogenous developments could have improved matters over time (see Corsetti, 2010, De Grauwe and Mongelli, 2008, and Torres, 2009).

At the Lisbon European Council in 2000 EU member states also agreed on reinforcing EU economic policy coordination by committing to a common economic reform agenda. The so-called Lisbon strategy (2000-2010) was developed at subsequent meetings of the European Council and became also known as the agenda for growth and jobs after its mid-term refocus on deliverables (growth and employment) in 2005. It was above all motivated by the need to address the challenges associated with worldwide competition (globalization).

According to traditional OCA theory, the condition for a country to surrender its monetary autonomy and join a monetary union is that the (microeconomic) efficiency

[9] Jones et al. (2016) argue that the incompleteness of EMU was both a cause of the euro crisis and a characteristic pattern of the policy responses to the crisis.

gains must outweigh the macroeconomic costs of participation. Those factors are dependent on the characteristics of the country in question. OCA theory has tended to focus on the stabilization policies (the macroeconomic costs) in a monetary union, namely the loss of the exchange rate as an adjustment mechanism.[10] In a recent paper, Campos and Macchiarelli (2016) revisit Bayoumi and Eichengreen's (1993) seminal contribution and evaluate (for the period1989-2015) what effect EMU had on the core-periphery pattern that the latter authors had found for the period pre-dating EMU (1963-1988). They conclude that the core-periphery pattern has actually weakened within EMU. Campos and Macchiarelli's preliminary results suggest that EMU did not move further away from an OCA. After all, as in any monetary union, the decision to go ahead with it was essentially political, based on the expectations that preferences would then sufficiently converge to allow for the completion of the economic union with regard to the requisites for sustaining monetary union (Torres, 2009).

In fact, EMU enjoyed a rather successful first decade by many accounts. At the same time, EMU's incompleteness – rooted in an incomplete institutional model beyond monetary policy – implied persistent institutional fragilities and allowed for building up financial, fiscal and competitiveness disequilibria. The lack of national reforms in some member states also contributed to growing intra-EMU macroeconomic imbalances.[11]

In the EU, the increase in economic integration to a monetary union had brought about a qualitative change, in which different member state varieties of capitalism (different conceptions of the mixed economy, with different state-market relations), when in contradiction with additional monetary union requisites on the economic side, became no longer sustainable. Albeit to different degrees, member states – especially those which were to experience severe problems later on in the sovereign debt crisis – failed (some of them significantly) to internalize what living in a monetary union meant, let alone to internalize the challenges posed by globalization, and delayed long-due reforms. Any

[10] For an analysis of the role played by OCA theory in the process of European monetary integration, see Krugman (1993), Mongelli (2008), Mongelli (2010) and Eichengreen (2014). For a critical appraisal (namely of the unreliable role of the exchange rate or of labour mobility as adjustment mechanisms) as part of the more recent transatlantic debate on EMU as a non-OCA, see Schelkle (2016).

[11] As argued in Bongardt and Torres (2013b), most EU countries had failed to internalize the established common objectives of fiscal (SGP) and economic and social governance (the Lisbon Strategy and its successor, the Europe 2020 Strategy).

proposed remedies – as it were, even more so under time pressure – would necessarily be more 'intrusive' in member state affairs. After all, a country's permanence in EMU requires that it to comply with those commitments that it made under constrained decentralization, needed to sustain EMU.

The combination of the absence of market pressure during EMU's first decade – when financial markets failed to differentiate between the sustainability of public debt and external imbalances among participants – and non-binding and not enforceable commitments in the case of the Lisbon Strategy and binding but not enforceable rules in the case of the SGP contributed to the procrastination of some of those (economic and institutional) reforms. The same holds true for the announced objectives (various times voted in national and European elections) to which various governments and political parties had subscribed and which were poorly implemented. It is therefore hardly surprising that economic policy coordination, effected through the Lisbon Strategy and the SGP, failed to deliver during EMU's first decade.

The combination of the lack of national reforms in some member states, in conjunction with the incapacity of financial markets to distinguish between Eurozone sovereigns, paved the way for increasing intra-EMU macroeconomic imbalances. Apart from its weak enforcement, the Lisbon Strategy also lacked any specific EMU dimension to address the increased interdependencies between members of a monetary union.

EMU's incompleteness in the economic union part left its (financial, fiscal and economic) governance institutions unable to encompass increasing policy interdependence, let alone capable of dealing with the cumulative effects of the financial and sovereign debt crises. EMU institutions, already affected by the 2008–9 global financial crisis, were unable to deal with the sovereign debt crisis that began in 2010, as there were neither financial backstops for stressed sovereigns or strained banks nor for countering sudden stops in financial flows (Mongelli et al., 2016).

The EU did move towards increased coordinated financial supervision in response to the 2008/9 global financial crisis, but it was insufficient. The subsequent sovereign debt crisis was a Eurozone crisis. The large negative spillovers, originating in the economic part of the union where there had been insufficient financial, fiscal and economic policy coordination and domestic adjustments to prevent macroeconomic

instability and imbalances, affected the monetary side (Torres, 2015). They came to put at risk even the survival of the monetary union. The sovereign debt crisis thereby added urgency to the completion of the economic union side of EMU. Member states responded by seeking to address the causes of the crisis, namely banking sector fragilities, budgetary disequilibria and competitiveness differentials between member states.

4. How to complete EMU?

4.1 The causes and the (more or less centralized) proposed solutions to the crisis

A growing consensus has emerged on the causes of the crisis (Baldwin et al., 2015) and also on EMU's fragilities that need to be corrected. It is summarized in Baldwin and Giavazzi (2016) and includes: completing the missing one-and-a-half pillars of the currently incomplete banking union; breaking the feedback loop between banks and their over-indebted sovereigns; securing Eurozone-wide risk sharing for dealing with Europe-wide shocks and coordinating fiscal policy / national fiscal policies while reinforcing discipline at the national level; some sort of sovereign debt restructuring mechanism for the Eurozone in order to redistribute the burden of legacy debt ("cleaning up the legacy debt problem"); and advancing structural reforms to push the Eurozone more towards an OCA.

As yet, there is no consensus on the specifics of the additional demands on economic union with respect to macroeconomic stabilization, notably whether fiscal policy needs to be centralised (De Grauwe and Ji, 2016a and 2016b; Tabellini, 2016) or not (Eichengreen and Wyplosz, 2016, Gros, 2016). There is also some controversy on the role of the ECB as a lender of last resort.[12] The legacy debt problem seems to be the most important political obstacle that stands in the way of most of the other necessary corrections. There are various proposals for a limited set of measures to be implemented as fast as possible, without any need for deepening political or even economic integration for which there is little appetite today.[13] However, all of these proposals encompass the

[12] See De Grauwe (2013), Eichengreen (2014), Torres (2013) and Feld et al. (2016) for a discussion.

[13] Corsetti et al. (2016) put forward a mechanism to redistribute the burden of legacy debt over time and only to a minimal extent across countries, which does not require debt mutualisation or a joint debt guarantee.

creation of some fiscal space at the level of the Eurozone and some sort of (more or less limited) programme of debt consolidation/restructuring. A second important political obstacle, stressed by Sapir (2016), is the resistance to creating Eurozone-wide risk sharing for Europe-wide shocks (which begs increased fiscal integration) for fear that structural weaknesses in some countries, in particular in the functioning of labour markets, may lead to structural rather than temporary fiscal transfers.

On the other hand, it has become more or less consensual that the one fundamental ingredient for a sustainable monetary union is banking union (Baldwin and Giavazzi, 2016; Eichengreen and Wyplosz, 2016; Gros, 2016; Gros and Belke, 2016). However, the question is whether such a banking union can materialise without a fiscal backstop, that is, a significant move towards a fiscal union.

Member states have resisted the centralization of competences on the economic side of EMU. It is uncertain whether this will change any time in the future, even with a UK exit from the EU and therefore less opposition from within. Still, as Buti and Lacoue-Labarthe (2016) suggest, abandoning a negative narrative on European integration (overcoming the institutional relations inconsistent trinity), which has characterised both mainstream parties and the civil society at a domestic level and was most prominent in the UK, is of fundamental importance to achieve the adequate level of subsidiarity that is needed for EMU to deliver. It remains urgent to address the above-referred challenges and to make the necessary institutional changes, which call for overcoming intergovernmentalism (overcoming Buti and Lacoue-Labarthe's political integration inconsistent trinity) in favour of 'the Community method as an adequate setting for multilevel governance'.

4.2 The Presidents' Reports on the completion of EMU

The process of creating new institutions and mechanisms has displayed significant political and institutional resilience in the face of the crisis. The crisis triggered advances in economic governance that took place through a multitude of successive steps, driven by market pressure and motivated by the need to ensure the survival of EMU. As a result, since 2010 different measures have been adopted with a view to strengthening fiscal

discipline and economic coordination, which have come to address some of EMU's fragilities. These responses, together with the creation of the European Stability Mechanism (ESM) as a permanent rescue fund, new arrangements for financial regulation and supervision and better tools for macro-prudential supervision, arguably reduce the risk of future crises and strengthen the capacity for crisis management. However, and although those incremental steps add up over time and foster further integration, a "complete EMU" seems always beyond reach (Jones et al., 2016; Pisani-Ferry, 2016).

The EU Presidents' Reports (Van Rompuy et al. 2012; Juncker et al. 2015a and 2015b) set out to address EMU's design flaws. Generally speaking, those derive from the fact that the functioning of an economic and monetary union, as compared to a stand-alone economic union, makes additional demands on the economic union side (notably on labour, product and financial markets with regard to flexibility and coordination requirements), which were previously unaccounted for. The Presidents advocate the necessity to respond to the Eurozone crisis by completing EMU's economic union part by creating a 'genuine EMU' (GEMU). It is composed of four strands (the first three of them economic), constituted by a banking union, an integrated budgetary framework, an integrated economic policy framework and enhanced democratic legitimacy and accountability of EMU governance.

However, efforts to create a 'genuine EMU' have only made limited progress. Fiscal integration did not progress much since 2011. On the other hand, financial integration (banking union) progressed substantially, although one-and-a-half of its three pillars are still missing. And with regard to an enhanced democratic legitimacy and accountability of EMU governance, the institutional steps taken during the crisis appear not to have been significant. One should however point out that a non-negligible informal bottom-up process of political integration has been occurring through the substantially increased politicisation of multi-level governance (Torres 2015). That notwithstanding the crisis failed to mobilize governments and citizens around a new impetus for European integration.[14]

[14] This fact raises the question of the longer-term political sustainability of both EMU and the European Union project (see Jones and Torres 2015 and 2016).

Among GEMU's four strands, it was the integrated economic policy framework that has progressed the least during the crisis and especially so since 2012 (Mongelli et al., 2016; Bongardt and Torres, 2016a); it is still far from the level required to sustain EMU. One can therefore argue (see section 4 below) that the resilience of EMU is conditioned on the one hand by the completion of EMU governance (which Brexit may facilitate) but that it still hinges on the creation of sufficient adjustment capacity and ownership of reforms at the member state level, where preferences (and overcoming a negative narrative of scapegoating the EU in national debates) have been slow to converge (which Brexit may also facilitate).

In fact, the reports advocate that policy adjustment in the Eurozone cannot rely on macroeconomic policies alone, and that economic integration would have to be pursued along the lines of creating stronger incentives for structural reforms in low-productivity countries. This would allow the Eurozone to better meet the economic requirements of a currency union by improving the overall stability of EMU to macroeconomic shocks. The issue remains how to achieve structural reform, given that competences and policy instruments are in the remit of member states.[15] In the context of an integrated economic coordination framework which barely advanced, held back by member state competences, the Five Presidents' report (Juncker et al. 2015b) proposes building on the Euro Plus Pact, with its EMU dimension and focus on interdependencies, rather than on the EU-wide Europe 2020 Strategy, as to render constrained decentralization more effective in the EMU context. The report proposes to strengthen national reform efforts through competitiveness authorities at the national level. This innovation is an attempt to increase ownership and the effectiveness of reforms at national levels while continuing to rely on the non-binding commitments; moving to a legal base for commitments is only envisaged in a second stage.[16]

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[15] The proposal of creating incentives for promoting structural reforms for member states, such as a system of national reform contracts to be signed with EU institutions in exchange for financial support (Van Rompuy et al. 2012), did not gather the necessary political support across member states and was abandoned.

[16] This fact suggests that the report is sceptical as to the delivery of national structural reform through non-binding coordination (Begg et al. 2015). Sapir and Wolff (2015) propose the establishment of a European Competitiveness Council composed of national competitiveness councils and the creation of a Euro System of Fiscal Policy to oversee fiscal debt sustainability and an adequate area-wide fiscal position.

Next to the above-referred necessary institutional changes to complete GEMU, it is therefore the adjustment capacity and the willingness to implement economic reforms at the member-state level that remains crucial for a better functioning monetary union. Perhaps less obviously, the same applies to promoting sustainable growth and hence for a credible crisis exit strategy.

5. The importance of structural reforms for EMU resilience and sustainable growth

The sovereign debt crisis added urgency to dealing with the higher economic coordination needs between members of the Eurozone in the face of their increased interdependencies, for the sake of the good functioning and indeed sustainability of the currency union. Apart from the completion of a banking union and progress towards fiscal integration and other necessary changes, any attempts at moving the Eurozone closer to an OCA, or to at least transform it into a sustainable currency area (SCA), require reforms in areas where competencies have remained national.[17] For the time being, it is therefore only possible through structural reform and adjustment capacity at the member state level.

In the sovereign debt crisis market pressure surfaced as an additional source of pressure with respect to increasing the reform efforts of lagging member states. In addition, conditionality made an appearance in the context of the provision of access to funds for those countries that were cut off from capital markets for their financing needs. Thereby market pressure and conditionality provide additional enforcement mechanisms for softly coordinated economic reforms. The new crisis-enacted mechanisms and the conditionality-linked availability of funds seem to have started to positively affect the implementation of structural reforms. There has been an acceleration of structural reforms in laggard countries – including Greece, at least until 2014 – as a result of market and peer pressure and of formal and informal conditionality (Schmieding and Schulz 2014; OECD 2015). On the other hand, while ECB actions have had the effect of buying time for the implementation of reforms at the national level, this has simultaneously alleviated market pressure on member states to reform.

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[17] For a discussion of the concept of SCA in contrast to OCA, see Torres (2009).

It is noteworthy that the relevance of economic reforms rises in a context where fiscal policy is also constrained by the need to ensure a proper fiscal adjustment, which is due to the need for an enduring correction of the budgetary imbalance. The reason is that structural reform can increase the credibility of the adjustment programme whereby a more gradual fiscal adjustment can be achieved (Bini-Smaghi 2016). As Draghi (2016) emphasizes, even supporting demand is not just a question of the budget balance, but also of its composition, especially the tax burden and the share of public investment; put differently, fiscal policy can be used as a microeconomic policy tool in that it can enhance growth even when public finances require consolidation.

Structural reforms are also important with a view to higher potential growth (Draghi 2015 and 2016) and therefore for dealing with legacy costs and for successful crisis exit. Yet, the problem is that whereas appropriate structural reforms are growth enhancing in the long run, they often fail to bring about immediate benefits (IMF 2015), while causing frictions at a high political cost when they collide with entrenched interest groups or affect vulnerable social groups. With the sovereign debt crisis, the common objectives to which member states committed under the Europe 2020 Strategy have come to encompass increasingly salient political and distributional issues, not only in but also between member states. Since competencies (and instruments) have remained national, the enforcement, under market and peer pressure and conditionality, of reform objectives to which the member states had already previously committed carries the risk of being perceived as intrusive.

A sustainable growth strategy with structural reforms at the national level emerges as a pre-condition for a credible exit strategy and a durable recovery. According to the ECB (2015), the smooth functioning of EMU warrants growth that is sustainable in the long run, which implies that any economic recovery from the crisis needs to be durable. Sustainable – not only economically but also environmentally – growth thereby offers both a crisis exit strategy and adds to the wider benefits from EU integration. EMU can be sustained both in the more immediate crisis context and in the long run as part of a political sustainable integration project, which envisages high-quality growth and

respects longer-term budgetary challenges (Begg et al. 2015).[18]

EMU sustainability requires promoting long-term sustainable growth, and it needs to be achieved within the crisis context and given a one-fits-all monetary policy and budgetary constraints.

In the case of monetary policy, the European Central Bank, to which the conduct of monetary policy has been delegated in the EU, has consistently stressed the importance of structural reform for EMU's smooth functioning (see for instance ECB 2015).[19] While ECB actions – just like a more expansionary fiscal policy stance in the Eurozone – can buy (and indeed have bought) time so that member states can address their structural problems, they cannot solve them (monetary policy can smooth cyclical shocks but it is unable to solve structural problems). Structural reforms are therefore a precondition for generating sustainable growth and for putting countries on a higher potential growth trajectory (ECB, 2015; Draghi, 2016).

With regard to budgetary constraints, one should note that a fiscal stimulus (even if feasible) as such is unlikely to give rise to quality growth, unless it deals with the causes of competitiveness problems and provides the right incentives. Incentives for growth can be provided not only through the level but also and perhaps more importantly by means of the composition of expenditure and incentives on the revenue side, notably taxation (Giavazzi and Wyplosz 2016; and Begg et al. 2015; Bongardt and Torres, 2016a; Draghi, 2016). In addition, regulation (market rules) can be used to foster private green investments without incurring fiscal expenditure. Taxes carry a double dividend, in that they discourage inefficient behaviour and also provide receipts for the state.[20] The

[18] Economic growth will not be sustainable and any recovery not durable even on purely economic grounds, unless environmental damages and resource depletion and long-term, inter-generational effects are internalized; nor would it be politically sustainable.

[19] See Torres (2013) for an explanation of this 'invasion of other policy domains' by the ECB: it became a guardian of EMU once the EU's political system *per se* seemed incapable of providing timely and consistent solutions.

[20] With regard to sustainable growth, appropriate taxation and tighter regulation to promote green investments are a case in point. The use of fiscal instruments opens up the perspective of promoting sustainable growth by correcting incentives by shifting taxation away from taxing productive factors (such as labour) onto inefficiencies (like pollution). However, EU level fiscal instruments require voting by unanimity in the Council of the EU. Member states are free to impose taxes or cut subsidies at the national level but they are reluctant to do so if that implies competitiveness (cost) disadvantages in the internal market.

abolition of incentive-distorting inefficient subsidies (negative taxes), like the ones on coal, likewise reduces government expenditure and improves the state of the environment by lowering carbon emissions. The use of economic instruments (like taxes and transferable emission licences) that have dynamic efficiency properties promotes innovation and provides least cost abatement of pollution; as such they are very much in tune with the Europe 2020 Strategy goals of (green) growth.

6. External pressure, ownership and the sequencing of reforms

All EU member states – present and future, with the exception of the UK and Denmark – are to join the single currency at some time, after complying with the established prerequisites.[21] Still, perceptions on the desirability or urgency of advances in economic coordination and of national economic reform may vary across EU member states. The issue of economic reform testifies to the difficulties of internalizing spillovers in the EU and in the Eurozone.

Soskice and Hope (2016) shed light on why external pressure might – and indeed often has – failed to foster structural reform at the member state level. Their argument goes that external pressure works better with respect to austerity – seen as preferable to transfers, which are politically difficult – than to reforms of institutions.[22] The reason is that austerity is a more immediate concern in contrast to reforming institutions (which takes longer to produce results), so that preference is more easily given to the former. The authors attribute the difficulties underlying reforms to different member state preferences, which are in turn rooted in countries' different growth models.[23] They argue that in the

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[21] After the negative referendum outcome on EU membership on 23 June 2016, the United Kingdom (UK) is expected to invoke article 50 TEU until March 2017 as to voluntarily exit the EU. This would leave Denmark as the only EU country with a derogation from monetary union. Denmark, however, *de facto* shadows the Eurozone.

[22] The comparative political economy literature goes beyond OCA theory, which suggests in which areas reforms should take place to make a currency union like the Eurozone function well. The contribution of the comparative political economy literature on the Eurozone is that it adds insights as to why reforms (especially in the labour market, but not only) might have been stalling despite external pressure.

[23] In the Eurozone Soskice and Hope (2016) distinguish an export-led north, which characterized as traditionally harbouring preferences for fiscal discipline, monetary stability, and wage coordination, from a demand-led south, which they qualify as more inflation-prone, with strong public sector unions and low wage coordination.

Eurozone the two pre-existing growth models have ceased to function in symbiosis since the crisis, and that the lack of reform has in turn put strain on EMU. Put differently, Eurozone countries had failed to internalise the constraints associated with being members of a monetary union. As for the issue of convergence to a compatible and consensual growth model, one may note that the Europe 2020 Strategy has come to outline such a consensual European model of development, which of course needs to be further fleshed out. The most urgent problem is however to promote the convergence of preferences to such a sustainable model of development also in laggard countries.

Abstracting from the continuing weaknesses of the EU's economic reform agenda and the as yet uncertain outcome of suggested improvements (i.e. national productivity boards), the acceptance of structural reforms at the member state level can be facilitated if attention is paid to the timing and mix of structural reforms. The fact that structural policies may often produce results with a time lag or have costs in the shorter run, makes it politically important to get the timing right, for instance by anticipating those reforms that are already beneficial in the short run (De Grauwe and Ji 2016) and to achieve the right mix (Caldera et al. 2016).

In our view, those structural policies need to be geared to delivering a sustainable European model, adopting structural reforms that put the EU economy on a sustainable path, in short, deliver on the Europe 2020 growth objectives. They can be implemented even under the crisis-induced constraints.[24] In this context, and with regard to the political sustainability of structural reforms, sequencing is a relevant concern: those reforms that are growth enhancing in the short run should be prioritized, and private investment encouraged in ways compatible with fiscal constraints. This will avoid that structural reform and austerity do mingle in such a way as to push countries into problems they did not have.[25]

[24] See Begg et al. (2015). So far the more immediate concerns with the need to generate growth have somewhat eclipsed long-term sustainability concerns and their implications for future growth in the EU policy discussion (Bongardt and Torres 2013a). Structural reforms that modernize the economy are however a precondition for a shift to a sustainable growth pattern in all member states and also for a sustainable EMU. And they can be implemented under the present constraints.

[25] We thank Paul De Grauwe for calling our attention to this point.

Efforts by member states to create ownership of reforms are nevertheless crucial for avoiding any political backlash. As Gros and Belke (2016) show for the case of Puerto Rico, even a 'genuine' economic and monetary union (with a well-functioning banking union) like the US is unable to prevent regional failures. The case of Puerto Rico in the US bears many similarities with the case of Greece in the Eurozone. Both delayed overdue reforms and arrived at the brink of bankruptcy. The only (big) difference is that in the case of Puerto Rico there seems to be little criticism of the US dollar for the failure and of the US government for lack of solidarity (Puerto Rico is left to the mercy of the markets). Yet, Puerto Rico, member of a financially integrated monetary union, did not put the monetary union at risk. It did not receive any financial help from the US either, and entered into default. In the case of Greece, Eurozone partners paid the country's debts to the IMF (which were overdue) and to the ECB.

Of course, the EU could move towards US practice, establishing a credible non-bailout regime. This would then make it possible to rescue banks without bailing out the sovereign. In that scenario member states would be free to choose whether or not to comply with reform commitments. By not modernizing, those member states would put at risk their respective national welfare states as well as the quality of life of current and future generations, while they alone would suffer the consequences of their political choices.

By opting for Brexit, the UK seems to have assumed the consequences of harbouring different preferences from the club. This fact could facilitate the club going ahead with the necessary institutional reforms to complete EMU. It follows that Eurozone countries with too divergent preferences might choose to leave the single currency. However, as it stands Euro exit is not foreseen in the Treaties, which allow for voluntary exit from the EU but not for Euro exit alone. In the current situation, however, any member state that chooses to not comply with its commitments under constrained decentralization to sufficiently reform and modernize its economy and society as to be part of a dynamic economic and monetary union, ought to assume political responsibility for the choice. Member states are of course free to follow a different economic model but should to do so without putting at risk the Eurozone's common good of monetary and financial stability and other Eurozone members' budgetary sustainability. If solidarity is

to work at the EU level, countries cannot maintain irreconcilable preferences with the club and should be ready either to adapt or to leave the union altogether.

As the cases of the various adjustment (bailout) programmes in the Eurozone have demonstrated, without increased sovereignty sharing the new EU governance framework still remains vulnerable to adverse market and political-economy pressures. So far Cyprus, Ireland, Portugal and Spain seem not to have succumbed to the Greek disaster (Greece is still under a bailout programme, the third one), although the jury is still out also for these countries as well as for other member states, notably Italy and France. Therefore, even if macroeconomic stability was to substantially improve, the as yet incomplete recasting of the governance of EMU leaves it at risk without structural reforms.

The lack of ownership of economic reform by a national government, notably Greece, has not only proven disastrous for the country but has also carried a high cost for the other members of the Eurozone (Bongardt and Torres, 2016a). In the end Greece, or for that matter any other EU member state, has the choice between addressing structural reforms in order to move on to sustainable growth (and, therefore, also to a fairer model of society) or having to be prepared to accept deteriorating living standards and internal social cohesion and quality of life vis-à-vis its partners. However, given the interdependencies in the monetary union, the latter option imposes also a heavy cost on its Eurozone partners and may well put at risk the very survival of EMU.

7. Conclusion

This article argues that EMU needs more homogeneous preferences in order to function and deliver, namely to complete institutional reform and to ensure that its economic union side fulfils the requisites to sustain its monetary union. Given the insufficient progress thus far on an integrated economic framework it also stresses the need for structural reforms at the member state level for EMU resilience in the face of (asymmetric) shocks. This will require a coordinated effort by all EU members based on significantly more convergent preferences on how to sustain EMU and achieve a durable exit from the crisis. For that it is necessary to have a more homogeneous and cohesive but

also more integrated EU core (the Eurozone).

The completion of the economic side of EMU with the aim to sustain the single currency and also deliver on the EU's wider objectives implies that the single market cannot be regarded as static nor the economic union be taken as a stand-alone construct. It is in the legitimate interest of present and future Eurozone members (all EU members except the Denmark and the UK, which is however to leave the EU) that the economic union sphere be deepened with regard to Eurozone requirements, in light of the increased interdependencies between members of the monetary union. This requires both advances on EU-level institutional modernization and structural reform at the member state level in the face of globalization.

Brexit has the potential to turn the EU more homogeneous in terms of preferences and to allow EMU to function better by some accounts. For instance, financial regulation in the single market can be better geared towards the Eurozone's public good of financial stability, and without UK opposition it might also prove easier to bring intergovernmental economic agreements within the Community framework at some stage. Moreover, the fact that Brexit opened the door for any discontent EU member state (whether actual or potential EMU members or EU members with an opt out from monetary union) to exit the club ought to reduce any member state's capacity to hold up decisions that are in the common interest, and to that extent can be expected to facilitate decision-making and problem solving.

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