The Single Currency: Towards a Federal Europe?

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Preface

The Economic and Monetary Union is at a crossroads. Established with high hopes, the eurozone has been unable to overcome the financial difficulties it has tumbled into. Originally, the monetary union was a political project. Speculations about the potential uncertainty factors involved were disregarded, even though many economists, especially in the USA, warned of the risks. Unfortunately, those words of caution have now come true.

The EuroThinkTank, a working group representing economists, experienced professionals in the financial system and a statistician convening at the University of Helsinki during 2013–2014, took it upon itself to analyse the underlying reasons of the economic and political crisis afflicting the eurozone and to assess the future of the euro. Of special interest to the group was to examine the options available to Finland, a small euro member.

The EuroThinkTank was created for the purpose of assessing and understanding the causes of the euro crisis and envisage the future of the currency. In their thinking, the think-tank members were united by a sense of disappointment with the economic development of the eurozone, the rhetoric nature of the policy on the euro and the lack of diversified argumentation in the assessment of its performance.

The think-tank held that the foreseen political union, banking union and fiscal union will push the eurozone towards a sort of practical federal state, referred to as the 'weak federation' in this report. These developments, however, are not based on any democratic process in which the citizens would be heard. In reality, national parliaments enact specific legal amendments prepared by EU officials that will amount to restricting the options available to the euro members. If the current policy line continues, Finland, among others, would end up in a situation where it could only declare itself to be a member state of a weak federation or leave it once and for all.

It has also transpired that conflicts of interest between individual member states cannot be overlooked in the assessment of the future evolution of the eurozone. States facing a sovereign debt crisis demand that their problems be resolved through solidarity, while member states that have put in a better performance in looking after their public finances object to joint liability. Germany's position on joint liability is, in the final analysis, ambiguous. In its export trade, the country benefits both from a fixed internal exchange rate within the eurozone and an international exchange rate value lower than what Germany's national currency would be.

The report seeks to convey a message to Finland's political decision makers: Finland must not remain adrift because it has a range of options. Finland must not continue to be a country of a single truth when its national interests are at stake. Politicians come and go. The national interest is constant and permanent.

Helsinki, May 4, 2014

Vesa Kanniainen, Professor of Economics, University of Helsinki
Introduction

The euro celebrated its 10th anniversary on 1 January 2009. Initially, the common currency appeared to be a success. The interest rates on sovereign debt in the eurozone had converged and its economy had grown at the same pace as that of the USA. The TARGET transfer system of the European Central Bank (ECB) worked smoothly, the financial system was highly integrated, capital moved freely across borders and the rate of inflation was low. The euro was held in high regard in the currency market and its future looked bright indeed.

Since the Second World War, the development of Western Europe has been dominated by the idea of ensuring unity and avoiding wars through joint economic interests. With the establishment and enlargement of the European Union, the dream of a common European family was strengthened further. To add momentum to integration, a common currency was proposed. A shared currency, free competition and wise economic policies were expected to boost economic activity within the eurozone, harmonise the cost of labour and narrow the gap in living standards between individual countries. However, the financial crisis which began in 2008 showed that the scheme rested on unrealistic expectations. The promising early years of the eurozone proved to be an illusion. In fact, the first decade of the EMU (Economic and Monetary Union) increased economic imbalance between the euro members.

Most probably, the current seemingly stable period gives a wrong impression of the state of the monetary union, once again. Sustaining the euro system may require sacrifices of such magnitude from the citizens of the euro members that they have until now been by-passed by politicians due to a lack of courage. An X-ray examination of the euro crisis is still wanting. The problems of the monetary union cannot be solved by rhetoric means. Consequently, the report raises the following questions:

(i) Why is the eurozone in crisis? What is the magnitude of the welfare losses the crisis has led to?
(ii) Do the political union, banking union and fiscal union represent solutions that promote democracy, economic efficiency and the general welfare and security of the citizens?
(iii) Is a full-blown federation a better option than the current trend towards a weak federal state, or are we heading for the re-adoption of national currencies?
(iv) What are the options available for Finland?
1. The European Monetary Union – A Political Project

1.1 Integration in Europe – no more war

From the point of view of the peoples of Europe, the achievements of the European Union over the past 60 years appear mostly positive. First and foremost, the EU has been a project for peace and cooperation between national decision makers. Its values call for a unification of economic interests between European nations by putting in place a single market to improve economic efficiency and by promoting the free movement of goods, services, labour and capital. Another important value is the advancement of the principles of the rule of law in European countries. Peace, the creation of an internal market and the rule of law are ‘products’ that the markets can promote but do not automatically generate. This is why implementation calls for joint decisions at the political level.¹

It is not gratuitous to remind that over a period of a little more than one hundred years, no fewer than three major wars were waged in Europe (during 1870–71, 1914–18 and 1939–45). The efforts to bring about European unity must be understood in the context of these historical traumas. ‘No more war’ became the overriding objective, and rightly so.

Germany, defeated in the First World War, was brought to its knees. It was required to pay massive reparations. On top of it all, the post-war German economy was gripped by hyperinflation. Although twice defeated, Germany has, for the third time, risen to become the leading great power in Europe.²

In 2012, the European Union received a major honour in recognition of its role in promoting and securing peace in Europe: it was awarded the Nobel Peace Prize. It was richly deserved.

At the same time, it has transpired that another key political motive for strengthening the European Union is the ambition to create a robust political and economic counterforce, particularly to the concentrations of power represented by the USA and China. Most likely, this motive is specifically pronounced in the large EU member states.

The idea of the common currency – the euro – has been promoted as an economically efficient and affordable solution to the community on the one hand, and as an institution that will become indispensable when the community is transformed into a federation on the other. Throughout the process of European integration, the common currency has had a dual role. First, it is an economic institution that allows the eurozone’s central bank to pursue a centralised monetary policy. Second, it is a tool which, through its mere existence, propels the evolution towards a federation and so creates the framework for conducting a centralised financial policy.

At least in the short and medium term, the Economic and Monetary Union will remain an alliance of independent states as far as its administrative structure is concerned. However, it is a well-known historical fact that alliances of independent states are administratively notoriously complicated structures with relatively short lifespans. We will return to these issues in more detail.

1.2 Aversion towards floating exchange rates

¹ To express this in the language of economics, it is a question of public goods as opposed to private goods, generated by the markets. More specifically, public goods include the services provided by the judicial system, the road network, the knowledge generated by universities (basic research), national defence solutions and internal security. Of course, all of these are not produced at European union level; instead, some of the duties have been left to the national institutions in accordance with the subsidiarity (subsidiarity) principle. This issue was addressed early on by Hans-Werner Sinn in his article “How Much Europe?”, Scottish Journal of Political Economy, 41, 1994, 85–107. Since then, Professor Sinn has been the leading representative of analytic research into the euro crisis in the European academia.

² Considering European unity and future developments, it is justifiable to raise the same question: is there at present any country in Europe which has been deeply traumatised by events in the recent past and which has voted to power a political actor keen to regain the country’s former position as a superpower? What significance does this question have in terms of the historical mission of the European Union?
If somebody were to propose a European monetary union today, the idea would most likely be rebuffed. We will present a calculation suggesting that to date, the monetary union has resulted in an average welfare loss of 10 per cent of GDP for its members. For many of these countries, the decrease has been much greater. These losses are permanent, not temporary. For politicians in Europe, the creation of the monetary union was first and foremost a political project. American economists warned of the risks involved even before the union was established. Similarly, distrust in the benefits of the currency union has been prevalent among the 10 EU member states that chose not to join it.

Among other things, the creation of the monetary union was based on the notion that fixed exchange rates are beneficial to the economy. It may justifiably be regarded as a fundamental error of judgement. Fixing the exchange rate compels the economy to adjust through other mechanisms – but Europe has lacked the will or capability to create and strengthen such mechanisms.

The aspirations of the Member States of the Economic Community to reduce exchange rate fluctuations resulted in the agreement on the European Monetary System (EMS). It took effect in 1979. Aside from a specific European currency unit (ECU) expressed in terms of the member state currencies, a central part of this arrangement was the Exchange Rate Mechanism (ERM). It restricted the mutual fluctuations of the member state currencies to 2.25 per cent above or below the agreed-upon average rate.

As a matter of fact, the actual fluctuations in exchange rates seem to tally with the predictions of the exchange rate theory. The concept of excessive exchange rate fluctuations in a post-Bretton Woods world started breaking down.3

FLOATING EXCHANGE RATES HAVE BEEN FEARED FOR NO GOOD REASON.

Following the collapse of the Bretton Woods fixed exchange rate system, the world economy adapted to the era of floating rates without problems. The export industries of the various countries fared well in the new conditions even if the exchange rate of the Deutschmark against the US dollar could fluctuate by up to 40% from year to year.4

Based on past experience, the International Monetary Fund (IMF) is leaning towards recommending floating exchange rates for small open economies.5 After the collapse of the Bretton Woods system, many countries continued to pursue the policy of fixed exchange rates; however, problems were looming on the horizon. In the early 1990s, unrest was evident in the West European currency markets keen to achieve and maintain stability. At the same time, Nordic currencies (Finland, Sweden and Norway) came under attack and collapsed one after the other. The British pound collapsed in 1992.

If the exchange rate is floating, little success can be achieved by attacking the value of the currency. This is because the value of the currency is determined ‘correctly’ every day in the market place.6 Only a fixed rate can be incorrect.7

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3 Also, Berstrand (1983), Frenkel and Goldstein (1988) and Bui and Pippenger (1990) challenged the view that exchange rates vary too much relative to the expectations based on the exchange rate theory. However, Diebold and Nerlove (1989) were able to prove that the volatility of exchange rates was not a constant; instead, the exchange rate variance keeps changing and can be captured by means of the ARCH model. The theoretical presentation was prepared by Sercu and Uppal (2006).

4 How important is the flexibility of the exchange rates in adapting to external imbalance? Grosh, Qureshi and Tsanagrides (2013) concluded that such flexibility accelerates the adaptation of national economies. Grosh, Ostry and Qureshi (2013) showed that susceptibility to macroeconomic and financial disruptions is significantly greater when the exchange rates are less flexible as compared to a situation when they are more flexible.

5 Cf. Olivier Blanchard, Monetary Policy Will Never Be the Same, IMF, November 19, 2013.

6 In other words, the value of a currency settles at a level at which sellers are able to sell the currency to buyers.

7 In such a case, the central bank has set the rate at a level that compels currency sellers or buyers to turn to the central bank to satisfy their need for currency.
Similarly, the experiences gained in Europe suggest that the currency snake in which currencies were tied to a mutual trade-weighted value was not enough to stabilise the currency market. From time to time, the currencies came under speculative attacks. The only permanent solution is provided by either a firmly fixed exchange rate as part of a strong union (e.g. the USA) or a genuinely floating exchange rate.

1.3 Finland and Sweden chose differently

Finland was among the first countries to adopt the euro as an accounting currency as of 1 January 1999. A widely held view is that Finland’s EMU decision was political and primarily motivated by foreign and security policy. A working group had been appointed to look into the economic implications of the Economic and Monetary Union. According to the working group, accession to the monetary union would expose Finland to the problem of how to adapt the economy to asymmetrical shocks, i.e. disruptions not experienced by other countries. The working group did not recommend joining the EMU. Even so, the tone of its report was favourable to the EMU and in that sense responsive to the wishes of the politicians.

In Europe at large, the question of the costs and benefits of the euro failed to attract any close attention among economists. In Sweden, a working party headed by Professor Lars Calmfors had arrived at the opposite conclusion already earlier. It held that Sweden’s accession to the monetary union would involve a major risk for various reasons.

1.4 The euro crisis is not over

The hopes pinned on the European monetary union when it was established have failed to materialise. The monetary union has descended into an economic and political crisis. Its survival beyond the critical stages in 2012 was due the declaration made by the European Central Bank on 26 July 2012. Mario Draghi of the ECB was compelled to give a statement which was highly exceptional in economic history: “[we will] do whatever it takes to save the euro”. To deliver on this promise, the ECB announced in autumn 2012 that it was prepared to buy up unlimited amounts of the bonds of the crisis-affected EMU countries.

By this declaration, the ECB sought to ensure that no member state would be compelled to exit the euro against its will. Whether the declaration is ultimately credible, remains debatable. If the ECB is called upon to deliver on its promise, it may be transformed into a record-large ‘bad bank’ holding a large quantity of non-performing assets. Is the euro really worth saving, whatever it takes?

2. Why the euro crisis?

2.1 Credit expansion in the eurozone

AN UNPRECEDENTED CREDIT EXPANSION TOOK PLACE IN THE EUROZONE AFTER THE ADOPTION OF THE COMMON CURRENCY. THE EXPLANATORY POWER OF OTHER FACTORS IS LOWER.

Often, underlying a credit expansion is lax monetary policy. Analyses of the Great Depression in the United States
focus on its consequences and the excessively tight monetary policy pursued by the US Federal Reserve during the depression. Less attention is paid to the credit expansion preceding it. Rothbart (1963) documented that in the 1920s, the average rate of increase in money supply expressed in terms of the M2 growth rate was 7.7% per annum and 61% overall. By 1929, a bubble had formed in the US housing and stock market only to burst with dramatic consequences: the Great Depression of the 1930s.

Similarly, the crisis originating in the USA in 2008 can be traced back to a lax monetary policy coupled with a failed housing market policy and, in particular, shadow banking operations. Also, there were regulatory failures in the supervision of the markets and financial institutions. FED, the central bank, kept the key interest rate for four years at a level deemed to be too low by a large majority of economists analysing the developments in retrospect.

Similarly, the prevailing view among economists is that the ECB’s monetary policy in the 2000s before the euro crisis was lax. According to the chart below, the M3 money supply increased in the eurozone by 106% during 2001–2008 while the average annual growth rate should have remained at 4.5% according to the first pillar of the Maastricht Treaty.

CHART 1

Growth rate of money supply (M3) and lending by financial institutions in the eurozone

Source: ECB

Lending to the private sector, such as companies, closely follows the increase in money supply.

Misplaced credits in the eurozone

Some of the crisis-affected countries, especially Ireland and Spain, invested heavily in the non-productive construction sector. While the construction sector in Germany accounts for less than 4% of its GDP, the corresponding figure during the building boom exceeded 12% for Spain and nearly reached 11% for Ireland. Yet it was not just ordinary people who incurred excessive debts. Public spending grew beyond the limits justified by tax revenues in the countries affected by the crisis. As a result, public debt increased. In the interest of economic growth, investments in the construction sector and generally, capital allocation by the public sector, should not be given priority.

2.2 Initial handicaps in the Economic and Monetary Union

Structurally, the Economic and Monetary Union is an alliance of independent states. The eurozone is far from the first of such alliances – world history offers ample examples of common currencies shared by several nations. However, characteristic of the most successful common currencies is that they have been currencies of federations, like the US dollar and the Sestertius of the Roman Empire. Of these, the still-thriving US currency area may be regarded as the most important example for the European single currency zone: the dollar area has remained unified for nearly 150 years and undergone several recessions during modern times, such as the Great Depression of the 1930s and the oil crises in the 1970s.

The US currency area differs from the eurozone in three important respects. There is only one official language in the area that all need to learn to a sufficient degree. Additionally – possibly because of the language
situation – the mobility of labour is far better than in the eurozone. Thirdly, the economic relations between the Federal Government and the states are governed by a strict no-bailout policy. States themselves are required to finance the programmes for which they are responsible under mutual agreements. However, the fundamental treaty does not, for example, prevent the Federal Government from contributing to the cost of major natural catastrophes on behalf of the states.

**IN THE UNITED STATES, THE DOLLAR WAS A FEDERAL CURRENCY RIGHT FROM THE BEGINNING.**

Since the eurozone was structured as an alliance of independent states, it was agreed at the outset that the member states would not assume liability for one another’s debts and that the public deficit should not exceed a specific limit. This was the purpose of the Growth and Stability Pact adopted at the Dublin Summit of the European Council during 13–14 December 1995. By contrast, no credible agreement was reached in view of a situation in which a member state failed to comply with these limits and was faced with a situation where its access to financing was about to be jeopardised because of excessive borrowing or budget deficit. The adoption of practically meaningless limitations as the main tool of financial policy coordination created a serious inherent structural flaw in the EMU.

Consequently, the most fundamental defect in the eurozone was ultimately political in nature. This is only natural considering that the introduction of the euro was basically a project stemming from political ambitions rather than economic realities.

### 2.3 Eurobanks – towards distorted balance sheets

The purpose of the monetary union was to integrate the financial system, improve its efficiency and create favourable conditions, particularly for efficient risk diversification. It did not come to be. True enough, progress was made with integration but cross-border financing contributed to debt bubbles in various countries. As banks became increasingly dependent on short term borrowing instead of traditional deposits, they also became more exposed to disruptions and credit ratings. Most importantly, the debt markets were fuelled by cheap money, for which favourable conditions were created by the key central banks, the ECB included.

During the euro’s lifetime, the financing base of the banking sector crumbled and its size relative to the production capacity of the eurozone grew out of proportion. Its capabilities for dealing with the crisis independently were inadequate, and remain so.

**BANKS RECEIVED CENTRAL BANK FINANCING BY POSTING GOVERNMENT BONDS OF INDEBTED EURO MEMBERS AS COLLATERAL.**

With the development of the short-term debt market, the share of conventional deposits in the banks’ financing structures fell systematically below 50% (Liikanen et al. 2012: p. 47).8

**CHART 2**

Evolution of the liabilities of MFIs 1998–2012 (EUR billion)

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8 The chart shows that the use of the banks’ own capital relative to the expanding debt declined substantially during the euro’s lifetime.
Large banks grew to become oversized banks.

**CAPITALISATION WAS LOWEST IN THE LARGEST BANKS.**

**REGULATION LED TO DISTORTED RISK PRICING, THE RELAXATION OF MARKET DISCIPLINE, INEFFICIENCIES AND FINALLY, TO MORAL HAZARD.**

### 2.4 Deficits in public financing before the crisis

To date, the provisions of the Growth and Stability Pact have been widely breached in several member states. Germany’s public deficit exceeded the 3% ceiling during three years (2002–2004), France’s during four (2002–2005) and Italy’s during five (2001–2006). Of the crisis-affected countries (GIIPS), Greece has violated the Pact every year. The same holds for Portugal as of 1993 except for one year.

Underlying the easy accumulation of debt is the evolution of the European bond market. Central to these developments were the arrangements made by eurobanks and the ECB, which gave added impetus to the growth of debt. The public deficits of the GIIPS and other euro members are illustrated in Chart 7.

**CHART 3**

Public deficits in the eurozone

* Germany, France, Netherlands, Belgium, Austria and Finland
** Greece, Ireland, Italy, Portugal and Spain

Sources: ECB and Bank of Finland calculations

### 2.4 The Absence of labour market flexibility

By fixing exchange rates, an economy loses a key adjustment mechanism. As a result, flexibility must be sought elsewhere. The labour market plays an important role in this. Underlying the deficits in the current accounts of the crisis-affected euro members are wage and productivity trends that differ from those of other eurozone countries to a substantial degree. For some time now, economists have held that EMU membership calls for considerable wage and price flexibility and/or mobility of labour. As early as 1953, Milton Friedman argued that if adjustments, in the face of major difficulties, were to be achieved through rigid prices such as wages instead of exchange rates, this would lead to deflation with all its harmful effects.³

All developments related to work and jobs affect people closely. For individuals, it is a question of livelihood. Usually, people are unable to diversify their sources of income by working at several companies, for example. Also, the bargaining positions of the employers and employees may be asymmetric. Consequently, it has been deemed advisable to regulate the labour market more closely than other markets.

A key role in the regulation of the labour market is played by the labour market organisations. A fair question is: which offers more security for people – a closely regulated or a flexible labour market? Is it possible that regulation provides security for some while failing to guarantee it for all?

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³ "If internal prices were as flexible as exchange rates, it would make little economic difference whether adjustments were brought about by changes in exchange rates or equivalent changes in internal prices. But this condition is clearly not fulfilled." ... "Wage rates tend to be among the less flexible prices." ... "If the external changes are deep-seated and persistent, the unemployment produces steady downward pressure on prices and wages, and the adjustment will not have been completed until the deflation has run its sorry course." p. 165, Milton Friedman (1953).
In the United States, people have the opportunity and capability to move from one state to another when hit by asymmetric economic shocks. Within Europe, however, mobility of labour is much lower because of language and other culture-related barriers. Migration is a double-edged sword. When educated people leave, it means a loss of valuable production capital to the country of origin.

The role of the cost of labour in the euro crisis is illustrated by the following table covering the euro’s first decade from 1999–2009, just before the major crises hit the GIIPS countries. The figures apply to industry and private services. The statistics are topped by the EMU members now embroiled in crisis. From 1999–2009, the price (unit cost) of labour in Greece increased by 61% while the corresponding figure for Germany was only 19%. It should be pointed out that across the border in France, the unit cost of labour went up by 34% over the same period.

TABLE 1.
Increase (%) in the cost of labour (industry and private services) in the eurozone during 1999–2009

<table>
<thead>
<tr>
<th>Country</th>
<th>Increase (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cyprus</td>
<td>109.6</td>
</tr>
<tr>
<td>Ireland</td>
<td>101.9</td>
</tr>
<tr>
<td>Greece</td>
<td>61.2</td>
</tr>
<tr>
<td>Portugal</td>
<td>57.7</td>
</tr>
<tr>
<td>Spain</td>
<td>44.2</td>
</tr>
<tr>
<td>Netherlands</td>
<td>43.9</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>43.0</td>
</tr>
<tr>
<td>Italy</td>
<td>37.9</td>
</tr>
<tr>
<td>France</td>
<td>34.1</td>
</tr>
<tr>
<td>Belgium</td>
<td>32.7</td>
</tr>
<tr>
<td>Finland</td>
<td>32.0</td>
</tr>
<tr>
<td>Austria</td>
<td>21.5</td>
</tr>
<tr>
<td>Germany</td>
<td>19.1</td>
</tr>
</tbody>
</table>

Source: Eurostat

As duly noted by researchers, the employed and unemployed have different interests. Trade unions promote the interests of the former, not the latter. Nickel (1977), among others, has found that countries with strong trade unions have higher unemployment rates than countries without. At the same time, the labour market mechanism affects the probability of the establishment of new companies.

For example, the Finnish labour market system was created in conditions in which large industrial companies offered work on a completely different scale than today. With globalisation, large industry has relocated to all corners of the world. Now, the SME sector has risen to the key position as a creator of jobs. In these new conditions, the role of the centralised collective bargaining system is bound to diminish.

**THE PATH OF INTERNAL DEVALUATION IS SLOW AND PAINFUL.**
3. The welfare loss of the euro countries

3.1 Estimating the welfare loss

The eurozone would have tumbled into difficulties even without the shock originating in the USA. The excessive sovereign debt of Greece and Portugal would have become evident to the markets sooner or later; the eurobanks would have proved to be real risk concentrations; a housing bubble was brewing in Ireland and Spain; most euro member countries ran current account deficits, etc. All these phenomena had a common denominator: the overly liquid money system and the inherent structural flaws discussed earlier. This chapter will provide a quantitative assessment of the potential size of the welfare loss incurred by the euro members.

This loss is illustrated in the graph by how far of its trend growth industrial production in the eurozone has fallen. Economic growth in the euro member countries was steadier after the currency crisis of 1992 than after the introduction of the euro in 1999. Subsequent development has been anaemic, particularly since 2008. The statistical assessment of the welfare loss in this report is based on a wider indicator, the evolution of the eurozone GDP.

CHART 4

Industrial production in the eurozone 1991–1/2014

Source: ECB, Eurostat

The assessment is made using several statistical models. They provide a statistical link in real growth of the GDP between the USA and the EMU.\(^\text{10}\) While this connection was extremely strong up until the end of 2007, it has since then broken. Using a factual correlation extending up to 2007, an assessment is made of by how much the eurozone’s real GDP is lagging behind, relative to the outcome if the connection had held also during and after the euro crisis.

Models used\(^\text{11}\)

The following models were used:

- Stochastic difference equation: the actual evolution of eurozone’s GDP is explained by its built-in delay structure and the actual evolution of the USA’s GDP.
- VAR model: actual real GDPs of the eurozone and the USA in inter-dependency.
- VARX model: eurozone’s and Finland’s GDP are explained by USA’s GDP in addition to the built-in delay structures.

We do not interpret the statistical dependencies such that the GDP observations could be explained by the used statistical time series alone. Rather, we think that the USA’s GDP serves as a surrogate variable for a larger set of

\(^\text{10}\) These models are subjected to diagnostic validation and the adequacy of the model with respect to the remainder term is determined in the ‘Hendryan’ (Hendry (1995)) spirit of statistical deduction.

\(^\text{11}\) For those interested in the techniques of mathematical statistics, the models are presented in Appendix 1.
phenomena affecting the GDP in the eurozone.\textsuperscript{12}

\textit{Results}

(i) Stochastic difference equation

During the model estimation period 1995 I–2007 IV, the development of the eurozone GDP follows that of the US GDP quite closely.\textsuperscript{13} In the following prediction period, the difference between the prediction yielded by the stochastic difference equation and the actual GDP produces a prediction error illustrating by how much the eurozone GDP differs from (lags behind) the prediction given by the model. By 2013 III, the cumulative prediction error (Chart) reaches \(-10.5\) showing how much the volume index of the eurozone GDP falls short of what is predicted by the model.

(ii) VAR model

By 2013 III, the cumulative prediction error yielded by the VAR model is \(-11.4\), which is fairly close to the cumulative prediction error provided by the stochastic difference equation.

(ii) VARX model

The VARX model yields a prediction error of \(-9.8\) for the eurozone. This, too, is consistent with what the two other types of models yielded.

\textbf{CHART 5}

\textbf{Stochastic difference equation cumulative prediction error}

It is only natural to interpret the result as indicative of the cumulative welfare loss. In a sense, it measures the distance by which actual GDP has fallen behind the potential GDP relative to the time path on which it would be if the euro crisis with all its consequences and policy actions would have progressed in the same fashion as the financial crisis in the USA.\textsuperscript{14}

\textbf{THE EUROZONE’S REAL GDP HAS FALLEN 10% SHORT OF WHAT IT COULD HAVE BEEN IF GROWTH HAD}

\textsuperscript{12} The models are estimated using observations from the period 1995 I–2007 IV. All the time series used in the models consist of seasonally adjusted quarterly GDP time series (in levels). After estimation, the models are used to generate a statistical prediction showing how the GDP would have been expected to develop if the laws operating prior to the euro crisis had applied during the period 2008 I–2013 III covered by the prediction. The predictions are single-step predictions formed by inserting the actual values of the GDP variable to be predicted in the estimated model equation in an effort to ensure that the prediction is as sound as possible in terms of its statistical properties.

\textsuperscript{13} Individual delays in the US GDP are not statistically significant but taken together, the last three delays in the US GDP are highly significant in ‘explaining’ the development of the GDP in the eurozone (p < 1%).

\textsuperscript{14} Of course, it makes no sense to compare the observed 10\% cumulative deviation to the fall in the GDP experienced during the Great Depression when it reached \(-33\%\) in the USA. At its worst, the eurozone GDP fell by 3.6\% in 2009. Even so, a 10\% welfare loss relative to what the economic growth could have been represents a significant permanent cost.
CONTINUED ON THE SAME PATH AS BEFORE THE FINANCIAL CRISIS.

As the US economy has coped with the crisis better, should this be taken to mean that a strong federation is able to deal with a crisis more effectively than a weak alliance of states? Is the prediction error as yielded by the model due to inherent structural flaws in the eurozone or political mismanagement of the crisis?

Arguably, the inherent structural flaws of the eurozone are serious considering how the US federal government has responded and been able to contain the crisis. Although the structural flaws of the euro did not materialise until the crisis erupted, would the eurozone have incurred lower welfare losses if a different approach had been adopted to manage the crisis? The model does not say. However, the claim that poorer performance in crisis management as compared to the USA is due to the eurozone itself – its inherent structural flaws and/or policies – is highly plausible. This view is supported by several observations:

(i) Before the USA-induced economic shock, developments in the eurozone followed the economic development of the USA quite closely. From 1999–2008, the real rate of growth in both regions was 2.3%.

(ii) Although the USA succeeded in getting back on the growth track fairly quickly after the 2008–2009 economic crisis, the eurozone has failed to do so. Its economy has been idling for years. Consequently, the stagnation of the eurozone cannot be attributed to the United States.

(iii) Nor is the stagnation of the eurozone due to other developments in the global economy. The world market prices for raw materials, including oil, have declined and the Chinese economy has so far continued to grow at a brisk rate. No such shocks have been sent to the eurozone by the world economy that would explain the halt of its economic growth.

3.2 Why is the growth view relevant?

The key question in evaluating the crisis facing the monetary union is the effect of the new EMU institutions on productivity and consequently economic growth, and the wellbeing of the citizens. Economic history clearly shows that even a minor difference in growth rate may, with time, lead to a dramatic cumulative loss. The growth rate is determined by institutions and their efficiency, or inefficiency.

Chart 16 illustrates the real per-capita growth in GDP from 1860–2004 in Great Britain, the United States, Sweden and Finland. A significant observation is made: by the year 1985, the world’s wealthiest nation (Great Britain) slips to the last place with the lowest income level in this group posting a total per-capita income that is only two-thirds of that of the USA. This dramatic cumulative welfare loss is a result of the difference in the average growth rate between the USA and Great Britain – a mere 0.4 percentage points per year.

CHART 6

Growth rates in Great Britain, USA, Sweden and Finland (1860–2004) in terms of purchasing power parity.

Source of data: Bolt and Van Zanden (2013)

Net contribution by the net payers to the EU is approximately 0.34% of GDP per year. In practice, these revenues are used for covering the EU’s operating expenses and overheads, and may not necessarily be enough in the long term.
From this perspective, it is decisive to the general welfare of the citizens whether euro membership generates more or less growth per capita. Even minor burdens escalate into major losses of income in the long run. For example, if the European Union persists as an additional 0.34 per cent expense item in the member states’ budgets as mentioned above, these countries will suffer the same fate as Great Britain over the period of time shown in the Chart.

4. The plans for an extended integration in the European monetary union

4.1 Is a currency union viable without a political union?

There are no examples in world history of successful currency unions between independent states. The Latin Monetary Union, throughout its existence, from 1865 to 1927 suffered from the attempts of some of the members to decrease the silver content of their coins (Einadi 2000). The rouble union established after the collapse of the Soviet Union crumbled within two years as a result of the policy of intense credit expansion pursued by the independent central banks of the member countries (Pomfret 2002). Of all the independent currency unions in Europe, the Scandinavian currency area formed by Sweden, Denmark and Norway during 1873–1913 is regarded as the most successful (Bergman 1999). However, the members of the currency union suffered from several asymmetric shocks. The CFA franc area in Central and Western Africa is probably the most functional of all the independent currency unions consisting of several independent countries. Even so, several countries have left the CFA franc over the years.

All successful common currency mechanisms that have been in operation for any longer periods of time have been either federal states or confederacies (Bordo and Jonung 1999; Bordo and James 2008; Capie 1998). While some independent currency unions have lasted fairly long, they have exposed the members to both external and internal shocks (Bergman 1999; Bordo and Jonung 1999; Zhao and Kim 2009). Additionally, currency unions have been troubled by slow economic growth (Zhao and Kim 2009). Central to the success of any currency union are political ambition and fiscal integration (Bordo and James 2008).

**ALL THE COMMON CURRENCY MECHANISMS OF LONGER STANDING FORMED BY SEVERAL COUNTRIES HAVE BEEN FEDERAL STATES OR CONFEDERACIES.**

Consequently, the history of currency unions shows that common currencies have been repeatedly exposed to asymmetric shocks (Bordo and Jonung 1999, Rockoff 2000). There is no reason to assume that the future of the eurozone would be any different. As a rule, common currencies have worked fairly well during times of an economic upturn; however, they may be hampered by differences in competitiveness and productivity. As a result of this, many states in the USA, for example, are more or less permanently net recipients of federal income while others are net contributors (Nordvig 2014).

When a currency union is hit by a recession or economic crisis, the biggest problem is posed by sudden stops. In such a situation, the flow of private capital suddenly turns away from the weakest member countries of the union. For example, the financial crisis of 2007–2009 was caused by the withdrawal of private capital from the southernmost countries of the eurozone to the north (Merler and Pisani-Ferry 2012, Sinn and Wollmershaeuser 2011).

The foreseen banking union and debt limits will do nothing to eliminate potential asymmetric shocks related to production or competitiveness, nor will they compensate the cost of such shocks to the afflicted countries. The effects of asymmetric shocks can only be compensated through transfers of income, a highly flexible national cost level, or monetary policy conducive to adjustment.\footnote{Shocks seldom take the form of dramatic crises. Most of them give the authorities ample time, even years, to adapt. The problem lies in the timely identification of the shocks and the subsequent consensus on the response.}
In many respects, the eurozone has re-lived the history of the currency unions of independent states. Consequently, in the light of this history, the eurozone is facing two economically viable long-term options: the road of deepening or diminishing integration. A deepening integration will lead to a federation and a diminishing integration to a partial or complete dissolution of the eurozone.

4.2 The idea of the European political union

Of all the member states, Germany is emerging as a key player along with the EU institutions. At the same time, France’s influence has waned as its economy stumbles.

General outlines of the political union advocated by Germany

The body politic in Germany wishes to turn the monetary union into a political union. Germany wants to lead it, albeit in collaboration with others. According to German political thinking, which is supported by all major parties, the political union would consist of the following three components:

1. A banking union that will include union-wide banking supervision, a single resolution mechanism, a crisis fund and a joint deposit guarantee.
2. A fiscal union that foresees a large common budget, a European Ministry of Finance, common taxation, eurobonds and extensive harmonisation of taxes.16
3. An economic union, a less clear concept than the fiscal union, which could include common growth and structural policies, energy policies, labour market issues and other economic policies.

POLITICAL UNION ADVOCATED BY GERMANY = FEDERATION

Banking Union Fiscal Union Economic Union

The French have added a Social Union to the model. The French finance minister has proposed common unemployment funds and employment-enhancing measures for inclusion in such a union. France’s political leadership often invokes solidarity between the euro members.

Why is Germany keen to keep the crisis-affected countries in the euro and advocate a political union?

According to public sources, Germany has saved a total of EUR 41 billion in interest expenditure on its sovereign debt during 2010–2014.17 Another, more important point is that Germany is able to maintain a current account

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16 Interestingly, the official Germany is still opposed to eurobonds. The question is: for how long?

17 The information is based on the 19 August 2013 issue of the Spiegel magazine. http://www.spiegel.de/international/europe/germany-profiting-from-euro-crisis-
surplus without risking any writedowns. This surplus stays as an engine of growth within the country while losses are ‘externalized’ to the other 17 euro members. Importers of German products finance their purchases partially through credit. Revenues earned by the exporters expand their banks’ capital, which is partly used for financing credits extended to the buyers.

Through its current account balance, Germany funds other euro members. As the cumulative surplus of the current account already exceeds EUR 1,000 billion,\textsuperscript{18} the euro is literally laying golden eggs for Germany. It’s not in Germany’s best interest to let any countries in crisis exit the euro. Moreover, Germany is more dependent on the euro single market than on the world market. At the same time, Germany benefits substantially from a weak euro relative to the country’s competitiveness. It has been estimated that if Germany had its own currency, its value against the US dollar could be as high as 1.60 whereas the euro-dollar exchange rate now trades around 1.38 (March 2014). A low exchange rate drives exports and makes imports more expensive. Consequently, Germany’s current account surplus is 7% relative to GDP.

The democracy deficit in the EU’s evolution and its future development schemes is serious.

Germany has all the time insisted that the political union should be accomplished by amending the Treaty on European Union. In exchange for solidarity, Germany has demanded progress in other aspects of the federalist evolution, primarily the banking union and the limitation of the freedom of the member states to pursue independent financial policies. For the time being, Germany has backed down on this demand, and so political solidarity has been implemented without amending the Treaty – and without hearing out the citizens. Prime examples of this are the EFSF, ESM and the Fiscal Compact as well as the OMT program by the ECB. How much is Germany still willing to give in?

Would a federalist political union be viable?

Would a federalist political union be viable and efficient in the first place? Many seem to believe so. In its discussion note, the IMF believes that a full-scale implementation of a banking and fiscal union would save the euro and secure stability in the eurozone.\textsuperscript{19}

Administrative regulation and discipline alone are not enough to make the federalist model viable and stable. We call this model the ‘weak federation.’ The Commission would implement regulations through the existing regimes (Growth and Stability Pact, six-pack, etc.), but their track record in the last few years is poor as far as effectiveness is concerned. To make such a model work, market discipline would be of pivotal importance. However, a fundamental problem is the extensive and growing joint liability between the member states, which works against market discipline. As a result, moral hazard grows, which means that the individual countries lose an incentive to look after their economies properly.

The democracy deficit in the on-going monetary union process is glaring. It would be justifiable to prepare a comprehensive package aiming at amending the Treaty on European Union and initiating the democratic process. If people support it, it can be implemented, otherwise not (cf. Nordvig 2014). But EU politicians lack the courage to put the issues to popular vote.

\textsuperscript{18} De Macedo and Lempinen (2013).

\textsuperscript{19} IMF Staff Discussion Note, “A Banking Union for the Euro Area”, February 2013; IMF Staff Discussion Note, “Toward a Fiscal Union for the Euro Area”, September 2013.
4.3 Banking union: do the authorities have the capability of preventing financial crises?

The supporters of the banking union use various arguments to justify it. Only a supranational agency is able to take into account the inter-dependencies between individual member states and their banks. The shared economic fate between individual member states and their banks would be broken down. Unhealthy liaison between national banks and authorities would come to an end. A change would take place away from public support for banks towards increased Private Sector Involvement (PSI) and investor participation in market risks. Only common authorities want or know how to treat all the eurozone banks in the same way.

Usually, the arguments for the banking union ignore the potential problems involved. No research exists demonstrating that a larger or a more international regulator would perform better than a national agency. True enough, the union will break the connection between an individual state and any of its banks hit by a crisis, but only because other states will have to bear the cost of the bank failure. As it is, the member states already foot the bill for the choices made by the eurozone decision makers.

Promoter of further integration

Particularly in a situation like the current crisis, the banking union serves to advance additional integration very efficiently. It will devolve decision-making and regulatory powers to supranational authorities while at the same time effectively leaving all the payment obligations to the member states and their citizens.

4.4 The roadmap to the fiscal union of the 18 euro member countries

Roadmap

The ambition to develop the eurozone’s economic and monetary union into a fiscal union is expressed in the report ‘Towards a Genuine Economic and Monetary Union’ published on 5 December 2012. It was signed by the President of the European Council Herman Van Rompuy; the Chairman of the European Commission Jose Manuel Barroso; the President of the Eurogroup Jean-Claude Juncker; and the President of the European Central Bank Mario Draghi. The roadmap foresees three phases.

Although the report aims at limiting national sovereignty in a number of ways and foresees the devolution of decision-making powers to the community level – the Commission and European Parliament – the report fails to evaluate the need for amending the Treaty on European Union in any way.

The first section of the roadmap addressing the years 2012–2013 deals with the development projects practically already implemented or being implemented: six-pack, the Treaty on Stability, Coordination and Governance (TSCG), two-pack, community-level banking regulation and deposit guarantee, as well as the determination of the principles for the recapitalisation of banks. The second part addressing the years 2013–2014 discusses the creation of the regulatory framework for managing banks in crisis. It also defines the role of the member states and their connection to the EU institutions in shaping structural policies.

The last part of the roadmap extending beyond 2014 goes furthest. The objective is to establish a community-level financial policy based on joint liability in order to manage economic disruptions affecting individual countries. This phase is assumed to be based on increasing community-level decision making regarding the member states’ budgetary economies. It is foreseen to lead to a growing coordination of the economic policies of the member states, specifically in taxation and the efforts to address unemployment. To strengthen the fiscal
capacity (the current term) of the EMU, plans are in place to introduce a community-level unemployment security system to replace equivalent national schemes. However, it would only be invoked if the national unemployment rate exceeded a given threshold value.

Money to finance the common funding scheme would be raised from national sources. Community resources would be strengthened by issuing community-level bonds. The ultimate goal of the fiscal union is seen in the creation of the European Ministry of Finance. A particular priority in the coordination of the community's financial policy seems to be in increasing flexibilities in the national labour markets.

Evaluation of the roadmap

The measures proposed in the roadmap seek to establish a strong disciplinary mechanism that will greatly limit national sovereignty. The role of markets in the creation of this disciplinary mechanism is perceived as secondary and, at best, complementary to community-level regulation. A strong bureaucratic streak is discerned in the foreseen implementation of the roadmap.

The democratic legitimacy of financial policy coordination appears limited. The proposal stresses that due consideration must be given to the common interests of the monetary union; in this context, national parliaments are not perceived as reliable actors. Accordingly, the proposal underlines the role of the European Parliament as well.

FISCAL UNION:
THE EU OFFICIAL (BIG BROTHER) IS WATCHING YOU!

An emphasis on cooperation between national parliaments and the European Parliament may lead to a situation where the large member states of southern Europe, and the Commission, may effectively ignore decision-making in the smaller member states in the north. For example, community-level unemployment security could only be claimed if the national unemployment rate exceeded a specific threshold value.

When the intention is to create a compensatory mechanism to cushion shocks affecting individual countries, it will – given the existing system of joint liability – mean income transfers to the crisis-affected countries in southern Europe. Here, solidarity would be a one-way street.

ROADMAP FOR THE FISCAL UNION:
WOULD IT BE NECESSARY TO AMEND THE TREATY ON EUROPEAN UNION TO IMPLEMENT IT?

Even before the roadmap prepared by Van Rompuy, a financial union to be created within the framework of the European Monetary Union had been proposed by the IMF, Tresor-economics of France as well as Bruegel, a European think tank devoted to policy research on international economic issues and headed by Jean-Claude Trichet.

Towards fiscal federalism

The roadmap for the fiscal union highlights the short-term stabilisation needs of the monetary union. In a federation, it would be natural for the community to take care of the stability policy. When responsibility for the monetary policy rests with the ECB, evidently the responsibility for financial policy and macro-economic stabilisation would fall to the Commission and the European Parliament (or an equivalent agency to be created for the eurozone countries). This would shift responsibility within the monetary union to the community level and increase its budget while at the same time reducing the latitude of the national budgetary policy.

Yet the roadmap glosses over the other dimension of the fiscal union, namely fiscal federalism. Fiscal federalism refers to the operation of a multilayered decision-making system on financial policies. These multiple layers involve the risk that public administration may not, on the whole, work efficiently. If it fails to do so, it will constitute a burden limiting the growth in national income levels, which may have major negative implications in
the long term. Hence, the key question is efficiency: what is the most efficient level for performing each function?20

In a European financial union, there would be (at least) three decision-making levels. The highest decision-making powers would be exercised by the European Parliament and executive powers by the European Commission. At the next level, there would be the national budgets in respect of which the decision-making powers, say, in Finland would be exercised by the Finnish Parliament. At the bottom, there would be the local (in Finland municipal) level.

A fiscal union would be tasked to produce public goods (security, social services) and certain private goods (health care, education), to create a social assistance system (unemployment benefits), establish a just income transfer system, and manage the stabilisation policy. Fiscal federalism as an economic architecture should be evaluated in terms of whether it increases or decreases economic efficiency. The key questions in view of a European fiscal union are:

(i) Which public goods can be produced the most efficiently at the monetary union level?
(ii) Which other budget economy expenditure items should be addressed at the community level and which should be left to the states?
(iii) What is the appropriate size of the budget to be created for the community level?
(iv) Which forms of taxation should be assigned from the national to the community level?
(v) How will the EMU fiscal union manage communication and incentive problems associated with multilayered decision making?
(vi) What are the ways to credibly limit and control the growth of the joint debt of the euro members?

5. The alternative futures of the European monetary union

The measures drafted as well as already agreed upon to save the euro will take the EMU towards deeper integration. Yet, the European Union is divided in a number of ways. The monetary union in its current state and its positioning towards the federalist project, reflect the tensions between the southern and northern members.21 A key role is played by Germany, which occupies centre stage in the monetary union decision-making whilst deriving significant economic benefit from the eurozone’s existence. Additionally, there are 10 EU member states that are not among the 18 euro members and so constitute a group external to this integration process.

5.1 Conflicting interests

20 During its 50-year history, the theory of fiscal federalism has shed light on the concept’s various aspects. The concept of fiscal federalism was developed by Richard Musgrave (1959). For an overview of this field of research, see Oates (1999).

21 The division between northern and southern member states is not exact considering that France and Ireland belong to neither group even though they have their own serious problems.
The economic crisis in the eurozone has led to divergence of the member states’ interests. Southern members hold that they are entitled to income transfers from northern members, at least for now. The former advocate eurobond-based joint liability in financing budget deficits, re-distributing the cost of over-indebtedness, managing the potential support measures required by eurobanks, and putting in place a joint deposit guarantee. In exchange, northern members – especially Germany – which are economically in a better position, call for strict control measures to oversee budgetary discipline, further demanding structural reforms to restore the member states’ competitiveness and capacity for adjustments.

The eurozone’s growth prospects are so bleak that its welfare losses relative to normal economic development and growth may well persist for a long time to come. From the point of view of the future of the monetary union, the economic performance of Greece, Portugal or Ireland is not decisive. What is decisive, however, is what happens to the large euro members. Italy, Spain and France are facing major problems in their economies. Italy, in particular, raises concerns. Although the country is already seriously indebted, its public deficit since the change of government has again begun to grow. Italy’s debt ratio is increasing towards 150% of GDP.

THE ECONOMIES OF ITALY, SPAIN AND FRANCE WILL SEAL THE FATE OF THE MONETARY UNION.

The hopes regarding the future evolution of the monetary union differ greatly in southern and northern member states. The citizens of the southern member states seem to think that their countries have already transferred wealth to their northern counterparts through foreign trade because the latter have accumulated current account surpluses within the monetary union.22 For this reason, the northern member states should, reciprocally, assume partial responsibility for the cost of the southern members’ national debt and balancing of budgets.23 Similarly, the principle of solidarity often expressed in the comments made by France is a typical demand made to the northern members and seemingly fully justified by the French.

INTRODUCTION OF JOINT LIABILITY IN THE FORM OF EUROBONDS IS ON THE AGENDA OF THE SOUTHERN MEMBER STATES.

Germany plays a central part and leads the way because of the size and performance of its economy and its large contribution to the Union. Yet its formal influence has remained limited both in the European Council, Commission and the Central Bank.24 The decision-making process in the EMU is very much driven by southern Europe: the Commission Chairman comes from Portugal and the President of the ECB from Italy. Additionally, according to some observers, southern European countries are over-represented among officials preparing the decisions. Since the IMF has been closely involved in the efforts to save the EMU, it is only natural to assume that it has served as another channel through which southern states have influenced decision-making in favour of their home countries.25

THE DECISION-MAKING PROCESS IN THE EMU IS VERY MUCH DRIVEN BY SOUTHERN EUROPE. THE CONFLICT OF INTERESTS BETWEEN NORTHERN AND SOUTHERN MEMBER STATES IS REAL.

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22 Finland did have foreign trade surpluses in respect of the rest of the eurozone, but only during the early days of the euro. Yet the trend has been declining all the time. As of 2008, Finland’s balance of trade in respect of the eurozone has run a deficit. Finland is one of the few countries never to have resorted to debt-restructuring (Reinhart and Rogoff 2009). Other such countries include Norway, Switzerland and Singapore. Sweden was compelled to reschedule its foreign debt in 1811 and Denmark its domestic debt in 1813.

23 The fact that Finland has EUR 155 billion in funded pension assets may be a source of envy in the countries where no such measures have been taken. In most countries, pension assets sit more clearly in private balance sheets. The same applies, among others, to the Netherlands and, in a sense, to the Finnish deposit guarantee system, the likes of which many of the other member states have never created.

24 Two Germans have resigned from the Board of the ECB in protest over the bank’s monetary policy decisions.

25 It should be pointed out that the President of the IMF and its chief economist are French. Most likely, a majority of the members are mainly interested in solutions that reduce the need of the eurozone to ask for emergency funding from the IMF for individual members. Quite possibly, another priority in the IMF’s decision making may be that the IMF would prefer to see a stronger European Union serving as a counterweight to the other major actors in the world economy, notably the USA and China.
The current state of the eurozone, often referred to as the EMU-2, means a departure from the Maastricht Treaty ("Maastricht 1"). The principles of ‘no bailout’ and the non-involvement of the ECB in supporting any individual country have ceased to apply. Moral hazard is winning ground in the monetary union both among the member states and banks. There is a widespread belief that at least the largest banks and their investors will be bailed out using public funds. At the same time, it has transpired that the willingness to adjust and take bitter decisions on national level wanes when funding is available\textsuperscript{26}.

During euro's rescue, steps have been taken that have shifted responsibilities from private investors to taxpayers and that are not legitimate in terms of democracy. Both the decisions to bail out and migrate decision-making powers from the member states to eurocrats have been made as if it were a question of due political process.

Primarily, responsibility for these decisions rests with the Commission and the ECB even though they have also been sanctioned by national governments and parliaments. At times, the authorities have been feeble in agreeing to the gradual transfer of their powers to EMU officials.

Most likely, the current situation, EMU-2, is just an intermediary phase because the need to limit the pursuit of self-interest by the banks and member states in exchange for funding will gradually lead to central planning (Germany’s goal). Similarly, it has been evident for a long time now that the Commission and the ECB will, in accordance with their respective missions, step by step take measures that will willy-nilly steer the development of the Union towards deepening integration and centralised decision-making.

It appears that the entire eurozone has only two stable options that do not involve any internal tensions regarding further development of the system:

(i) A strong federation consisting of the 18 euro members.
(ii) A return to national currencies, meaning the type of EU membership alike Sweden and Poland.

However, each individual country can determine the preferred level of integration for its own part. If this happens, a part of the eurozone may evolve into a federation whose currency is used by a group of member states content with a lower level of integration. Consequently, the member states have four options:

(i) Membership in a weak euro federation (most likely just a temporary situation like today).
(ii) Membership in a strong euro federation (likely outcome of ongoing and planned development of the EMU).
(iii) Keeping the euro but staying outside of any alliances (independence highlighted).
(iv) Adoption of a national currency or exit from the euro (national currency and economic policy highlighted).

\textsuperscript{26} In part, this may be due to the ECB’s promise to do whatever it takes to save the euro, evidently meaning the eurozone as well. This may be understood as an indirect pledge to continue to provide financing to a euro member threatening to pull out irrespective of the economic policy pursued by such a member.
Large countries, in particular, wield much influence when decisions on the future evolution of the eurozone are made. However, it is up to each individual member state – Finland included – to determine what in particular it is willing to agree to. If the eurozone does not evolve in a way that is beneficial to Finland, it doesn’t need to adhere to such decisions.

5.3 EMU-2 as a weak federation

Based on EMU-2, the eurozone would evolve into a temporary federation of independent states which would, step by step, be strengthened by new decisions. The foreseen banking union and fiscal union may just be enough to restore permanent stability to the finances of the member states and banks. This time around, the member states might actually stick to the agreements made. In case of a new financial crisis, the last resort would again be the ECB’s extreme monetary policy measures.

Consequently, the EMU can be reconstructed as a weak federation based on the following resolutions and principles:

- A banking union of some degree will be implemented (as principally already agreed).
- The fiscal union will basically contend with the financing and regulatory controls of national budgets already agreed upon.
- Although the idea is palatable to all, the pressure will increase to take new steps in addition to the existing resolutions regarding budgetary discipline. One such step would be the introduction of a tax payable to the EMU. In practice, this would probably take the form of annual payments of a certain percentage of tax revenues (2–3% of GDP) to the federation. If so, the weak federation could assume new duties.
- If the right to tax fails to materialise, the weak federation would finance just its own operations without any income transfers to the member states.
- The central bank will focus on monetary policy measures without offering financial support to individual countries.
- At some point, it will be possible to finally end joint liability and bank subsidies by implementing PSI on a broad front.
- The federation officials would be mainly tasked to ensure compliance with the regulations and norms, within which the federation operates.
- Aside from monetary policy and the federation’s foreign policy, responsibility for all other government duties would be assumed by the individual states.

EMU-2 corresponds more or less to what we call the weak federation.

In extreme cases, this could mean financing the public debt of the member states through the European Central Bank. Miettinen (2012) has proposed “massive monetary financing” based on the purchase of the euro members’ bonds in proportion to the ECB capital key. For example, in a EUR 1,000 billion LTRO operation, the ECB would buy Finland’s government bonds for EUR 18 billion and Germany’s for EUR 257 billion. Once begun, this monetary refinancing, or quantitative easing, could inflate the ECB’s balance sheet to trillions of euros as in the case of the US Federal Reserve (FED). A number of problems are also associated with “tapering” (a slow-down in buying) that the FED is currently wrestling with.

A federation created within the framework of the 18 EMU members would require the establishment of a specific administrative structure in addition to the EU’s existing administration.
Even so, the capacity of the weak federation to generate welfare may be compromised. Fiscal policy regulation may in the long term lead to growth and welfare losses because it limits the states’ ability to respond to economic downturns. As a result, recessions may become more severe, which will undermine the long-term growth rates of the members of the weak federation.

Historical evidence shows that the decision makers in the member states and the eurozone officials may ultimately prove unwilling to adhere to the agreed-upon principles. Therefore, there is reason to believe that the inherent structural flaws of the eurozone cannot be permanently overcome and so the measures taken by the weak federation will remain inefficient. Moreover, the supporters of a stronger federation will continuously seek to expand the mandate of central administration.

**THE ABILITY OF THE WEAK FEDERATION TO GENERATE WELFARE FOR THE CITIZENS OF THE MEMBER STATES IS LIMITED.**

There has been a strong, unwarranted belief in the benefits of the banking union which depends on regulatory control. Ample evidence shows that regulators repeatedly fail to prevent banking crises. This creates pressures to introduce joint liability sooner or later. Financial policy guidance and control are based on the restrictions imposed by regulations instead of continuous and flexible assessment made by the markets, i.e. market discipline. Economic history lends no support to the notion that banking crises could be prevented by supervision. Instead, banking crises can only be averted through the introduction of the right incentives within the banking system itself.

**ECONOMIC HISTORY LENDS NO SUPPORT TO THE NOTION THAT BANKING CRISSES COULD BE PREVENTED BY SUPERVISION. INSTEAD, BANKING CRISSES CAN ONLY BE AVERTED THROUGH THE INTRODUCTION OF THE RIGHT INCENTIVES WITHIN THE BANKING SYSTEM ITSELF.**

Although the euro crisis is not yet over, it is conceivable that the current state of the eurozone or its temporary subsequent variant – the weak federation – proves to be at least as long-lived as EMU-1. The ECB has mastered a technique by which crisis-affected markets can be stabilised, at least seemingly. Sooner or later, the improving economy and the, again, easy availability of funding will lead to sloppy management of public finances in some of the member states.

Another factor dimming the success of the weak federation, no matter how long-lived, is the massive debt incurred by a number of states. Large interest expenses restrict the flexibility of financial policy enjoyed by the countries, thereby imposing more stringent requirements to other forms of adjustment. There is lack of courage to take the step towards debt restructuring of the over-indebted member states (Greece, Italy, Portugal, Ireland, Spain and France).³⁰ At the same time, there is distrust as to the member states’ ability and willingness to reduce their debt burden. Greece is factually bankrupt. If its debt were restructured, the member states that have extended loans to Greece as well the ECB holding Greek government bonds both directly in its balance sheet and as collateral for bank credit would incur instant losses. Possibly, there is a reluctance towards debt relief because it would lower the living standard of the creditors without guaranteeing any results or increasing their influence in the area.

**Problem-ridden joint liability and Maastricht 2.0**

Some observers entertain the idea that, with the banking union, the EMU could return to regular housekeeping and that the no-bailout rule could be effectively enforced. This sort of Maastricht 2.0 scenario would mean that the

³⁰ Public debt as a percentage of the GDP in said countries: Greece 160%, Italy 130%, Portugal 125%, Ireland 125%, Spain 90%, France 90%.
evolution into a federation would be halted, for example after the implementation of the banking union.

However, no country has – either officially or unofficially – adopted the Maastricht 2.0 option as its main political strategy. Rather, the public positions suggest that the EMU will be developed towards a weak federation and that the next step would be the fiscal union. The question is only how extensive it would be and what are the steps to be taken to achieve it.

To date, no euro member has refused to accept limited joint liability in the efforts to contain the euro crisis even though the northern European member states are opposed to eurobonds, at least for the time being. Moreover, Maastricht 2.0 cannot be implemented quickly, i.e., not before the current crises has been overcome. Joint liability for balancing public finances remains a constant, real risk and the debt tolerance of the crisis-affected countries a persistent concern. Several comments were made in public in 2013 saying that a third tranche may have to be granted to Greece. Moreover, the ECB supports the crisis countries through its monetary operations. In reality, Greece may well be heading for a second debt restructuring. Greece is facing major solvency problems and is unable to pay off its debt without restructuring.

The differences in risks between the euro members are significant. Characteristically, at the same time when Finland’s Prime Minister recently announced a EUR 3 billion balancing programme (equivalent to around 1.5% of the GDP), Italy will increase its budget deficit by over one percentage point relative to its GDP. At the end of 2013, Italy’s public debt ratio was 133% and Finland’s 57%.

Southern European member states see eurobonds as the solution to the sustainability problem of their public finances. The idea is that euro members would raise funding using common bonds in order to cover their deficits. The market rate payable on debt would be the same for all. The countries in crisis would benefit from the sound credit standings of the countries that have managed their public finances well. The latter would have to pay excessive interest as compared to a situation where they borrowed directly in their own name. As a result, they would make their taxpayers liable for part of the debt burden of less credit-worthy countries.

Joint liability involves the risk of moral hazard: it creates an incentive to pursue national interests at the expense of others - the taxpayers of the net payer countries. As far as incentives go, it would be better if all countries shouldered their own share of the responsibility, something that the drafters of the Maastricht 1.0 treaty were well aware of.

THE JOINT LIABILITY ARISING FROM EUROBONDS INVOLVES THE RISK OF MORAL HAZARD:

Can Maastricht 2.0 have any credibility?

Will agreements between countries hold? Recent experiences and the history of currency unions are not encouraging. Maastricht 1.0 and the Growth and Stability Pact have been numerous times violated. In recent years, several key principles of the Treaty on European Union have been violated in practice. Is it safe to assume that existing and future agreements carrying insufficient sanctions would not be breached in the future as well?

5.4 A strong federation as the true political union

There are well-functioning federations in the world such as the USA, Germany and Switzerland. Other such entities outside Europe include the giants China and India. By contrast, the Soviet Union is an example of a federation that failed, both politically and economically.

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31 Slovakia declined to participate in the first bailout package for Greece by the decision of the Slovakian Parliament.
32 Such statements have been made by German Finance Minister Wolfgang Schäuble; Prime Minister Jyrki Katainen and Foreign Minister Erkki Tuomioja of Finland have endorsed this idea.
What are the main duties of a federation? Invoking the example of the USA, one could argue that the main task of a strong federation is to produce the public goods (national security, foreign policy and a free internal market as a minimum), provide social security for the citizens and assist the member states in the event of asymmetric shocks.

Among the main duties of a federation is to produce public goods, provide social security and assist member states in the event of asymmetric shocks.

Characteristic of a strong and successful European federation is that it would work largely in the same way as existing federations. A significant part of the member states’ (future states such as Finland) right to collect taxes or tax revenues would be transferred to the community level for use in its decision-making. While the European Union’s budget today is 1% of the region’s GDP, the overall level of taxes levied by a strong federation would, with time, probably reach 15–20% (as suggested by the equivalent level in the USA). Germany would rise to a key position as the leader of the federation. In a sense, Finland and the other small northern euro members would be states within a German federation.

Since Germany could not relinquish its own economic influence, it would have to look after its interests by ascending, in one way or another, to a leading position in the EMU’s decision-making bodies. It is by no means excluded that a strong federation could mean the realisation of the age-old idea of a Greater Germany. Obviously, it would only happen over a long period of time following fierce but unsuccessful opposition from the majority of other large euro members. While it remains highly obscure what such an economic and political process would look like, it would hardly be a pleasant experience for most EMU citizens.

How successful could a strong federation be in generating economic and social welfare? The EMU’s prospects for becoming a successful federation appear quite bleak, and for a long time to come. The applicable criteria could be outlined as follows:

- Sufficient symmetry of the member states’ economic performance.
- Reduced significance of asymmetric shocks.
- Compatibility of the labour market mechanisms (with required flexibilities) with the monetary union.
- Adoption of a credible budgetary discipline at the national level.
- Sufficient similarity in terms of political culture and values.
- Willingness to relinquish national sovereignty in favour of a federation.

Because of the present-day economic asymmetry between the member states, we are far from achieving a federation based on the EMU and turning it into an economic and political success. As it is, the interests of the member states are, at least in part, contradictory. Also, there are research findings suggesting that the US states would neither constitute a coherent entity satisfying the criteria for an optimum currency area. No doubt, some US states would have benefited from the additional flexibility provided by a state currency from time to time (Beckworth, 2012). The biggest obstacle to any rapid progress in building a strong federation may be presented by the different languages of the European peoples and their different social values.

In principle, a strong euro federation is feasible and potentially efficient in operation. Most likely, such a structure may only develop on a voluntary basis and, even in the best of cases, over a very long period of time. Until then, the eurozone will – almost by definition – operate inefficiently while at the same time probably undermining income generation. For a fairly long time, the eurozone would be in the same position as Great Britain

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33 Of course, the USA’s evolution into a federation was a long process. Among other things, it included a traumatic civil war.

34 Would the federation’s main language be English or a language of some large state in the federation?
was early in the previous century – the rest of the world outgrows it before the burden of the past can be shed.

In the foregoing, attention was drawn to the fact that the current juxtaposition in the EMU reflects powerful tensions between southern and northern euro members. This asymmetry is further intensified by large differences in income levels and the nature of the problems besetting public finances. Still, southern states hold that, as members of the same currency area, they are entitled to the same standard of living as northern states. When they cannot accomplish this under their own steam, they feel it is their right to receive at least temporary income transfers from northern member states. This policy can be accelerated by advocating joint liability based on eurobonds, an interbank crisis resolution mechanism and a joint deposit guarantee. As long as income levels between the countries depart as much as they do, a need for income transfers from north to south (and east) will persist. Consequently, to be able to limit income transfers, economic activity must increase in the south or decrease in the north, or both.

THE CRITERIA OF A STRONG POLITICAL UNION ARE NOT MET.

Membership in a monetary union seems to be of special attraction to countries whose own economies and public finances are not doing very well and that seem to expect economic benefits from such membership both in the form of economic activity and income transfers. Such countries do not include the UK, Sweden or Denmark.

In the distant future in which the EMU members will have established a strong federation, it will have the potential of becoming a major actor in the global economy. To establish a federation, it would be necessary to create a decision-making infrastructure based on democratic institutions. To accomplish this, it would be necessary:

– to transfer the highest decision-making powers in the European federation from national parliaments to a democratically elected European Parliament to the extent determined by the latter;
– for all the Member States to subscribe to a common, centralised foreign, security and trade policy;
– for political parties to reorganise as Europe-wide parties on the union level;
– to appoint a federal government accountable exclusively to the European Parliament, assisted by federal ministries;
– to subordinate national authorities to federal authorities to the extent those deem appropriate;
– to grant the federal defence forces, police and courts of law direct authority to act in the territory of the member states to the extent deemed appropriate by the central administration;
– to have a genuine political opposition in the European Parliament;
– that the Member States would retain independent decision-making powers up to a point, yet not the extent enjoyed today; to have federal institutions define the limits of decision-making powers (in Finland, the entities equivalent to the states in a federation would be the municipalities);
– for national courts to base their decision primarily on federal legislation.

A strong and well-functioning federation may be expected to offer economic efficiencies in terms of the production of public goods, the development of the single market (another public good) and improved management of

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35 Let us imagine a situation in which well-meaning MEPs pass a law stipulating that all citizens within the European Union are entitled to a basic income of, say, EUR 800 per month. What are the countries in which all work will cease immediately – Bulgaria, Romania, Estonia, Hungary, parts of Poland?

36 If a strong federation were an undisputed economic success, it would be hard to explain the public comments heard e.g. in Finland stating that a strong federation would not be an option for Finland.
national interests. Of course, all the problems of democracy – such as lobbying, advocacy of special interests, horse trading, the difficulty of pursuing a sound, long term economic policy, special treatment of big banks, etc. – would continue to beset any federation as well. The US political divide in recent years is a reminder that political decision-making and the development of the economy may be paralysed even in a strong federation.

From the point of view of individual citizens, a strong federation means relocating final decision-making far away. Considering the keenness of the eurozone authorities to issue binding norms regulating the various spheres of life, it is obvious that not much would be left to the discretion of the member states.

5.5 Return to national currencies

The reservations towards floating exchange rates are ill-founded. By contrast, fixing the exchange rate has often led to trouble. At the same time, it requires major adjustments on the part of the other sectors of the economy such as the labour market. This is due to the fact that fixing the exchange rate deprives the economy of one of the natural macroeconomic adjustment mechanisms in case of disruptions. The Exchange Rate Mechanism (ERM) tested in Europe before the EMU cannot be called a success. Nor does the current euro system qualify.

However, a bigger problem than short-term shocks is the currency union itself if it, because of its inherent structural flaws, leads to a permanent erosion of general welfare as compared to the rest of the world economy.

It is impossible to predict the EMU’s performance over the next 10 to 20 years. We have previously suggested that the eurozone, keen to establish a close-knit grouping, is in for a long period of time during which it will undermine rather than increase the income levels of its members. Despite the political commitments, a disintegration of the EMU cannot be excluded in the light of economic history.

Nor is it impossible for the monetary union to be dismantled partially: one or several of the crisis-affected countries could exit the EMU. The question is whether such an exit is in the best interest of the country involved. For example, Greece cannot have any strong incentive to leave the euro for as long as it lacks a significant export sector and can expect assistance from other member states. According to public sources, Italy, a country with a diversified production sector, considered leaving the euro in 2011. Conversely, one could expect a strong euro member to pull out if it could manage its economic problems on its own and if the EMU would just mean growing costs and weaker economic development.

Looking at the situation from another standpoint, there may be a natural explanation why the euro politicians have not allowed Greece to exit. In the light of economic history, it may be argued that Greece would, in fact, be already on a positive growth path if it had pulled out of the EMU and so allowed its currency to depreciate. The latest case supporting this view is the successful recovery of Iceland based on its own currency following an out-and-out collapse of its economy. From this perspective, it seems that funding to Greece has been continued in order to secure the unity of the eurozone.

Greece would already be on a positive growth path if it had pulled out of the EMU.

Contrary to conventional wisdom, the monetary union can be dissolved in a controlled manner. It would not lead to the catastrophic consequences as claimed by decision makers and even some experts. Following the dissolution

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37 Prime examples include the centralised regulatory and banking policy that is currently being contemplated. A party who could previously discuss issues with a national decision-maker would have to turn to an official based in Frankfurt. In reality, national authorities would only serve as executors of the decisions made by a centralised agency and as national commentators, or proconsuls.

38 Lorenzo Bini Smaghi, an Italian member of the Executive Board of the ECB, writes about Berlusconi’s plan in his book. See http://www.cnbc.com/id/101031815
of the EMU, euro-denominated debts and liabilities can be managed using currency solutions comparable to the
euro. For lawyers, the dissolution of the monetary union would not represent any bigger gold mine than the current
developments in the currency union.

In practice, the return to national currencies could be implemented through a basket currency or individual
exits. Nordvig (2014) and Miettinen (2011) have proposed a so-called ECU-2 basket (Euro 2.0 redefinition), which
would mean backtracking the same steps taken when the euro was originally adopted. The euro would be legally
defined as the basket currency largely in the same way as the ECU was defined before 1 January 1999 at a 1:1
exchange rate relative to the euro. In the basket currency, the national currencies would be adopted by each
member state side by side with the euro. Initially, they would be valued at a 1:1 exchange rate relative to the euro
and one another. After that, the rates would be floating and hence, be determined by supply and demand. Euro-
denominated contracts would continue to be euro-denominated contracts, except that now they would exist in the
ECU-2 context. The basket euro could continue to exist forever or, only during a transition period, and for as long
as any euro-denominated contracts are outstanding. While the markets would be able to price the contracts
correctly, even in the absence of a parallel currency, the legal country-specific definition of the euro would remain
ambiguous, for example in case of contracts governed by English law. This legal uncertainty could be eliminated
by the ECU-2 model. 39

True, this step would have its own consequences but the disruptions to the financial and banking system
would be moderate and a far cry from the threat scenarios so frequently espoused. 40 The currencies of weak
countries would weaken and their competitiveness improve while strong countries would experience the opposite.
Effectively, debts and receivables would remain euro-denominated.

If a basket currency was adopted, sovereign debt could stay euro-denominated. This would benefit
the creditors of weak countries as compared to a situation where the receivables were converted to a currency with a
lower value. Similarly, and importantly for companies, the euros in all euro-denominated currencies would be of
equal value irrespective of the governing law of the contract. Individual euro members could, within the limits
imposed by their legal systems and political realities, convert their debt into the new domestic currency, at least in
case of contracts made in accordance with the law of that country.

Household debts and existing investments would presumably remain euro-denominated (unless redefined
and converted into domestic currencies by way of legal amendments) but all future domestic market revenues
would be generated in national currency. The financial position of households in weak countries would
deteriorate and that of households in strong countries improve. From the point of view of the economy, the
situation would harmonise when the exchange rates even out differences in competitiveness, even if the
adaptation would be painful for some crisis-affected countries. While the Deutschmark would appreciate, the
national currency of, say, Greece would depreciate by dozens of per cents. For companies, it would be
straightforward to use national currencies and hedge risks using exchange rate derivatives.

A more detailed description of the processes for adopting national currencies is provided in Appendices 2 and 3.
The following steps are foreseen in the case of Finland:

39 Nordvig (2) has stressed the importance of legal aspects if the euro is phased out. Governments have the possibility of amending the financial agreements
governed by their own respective laws. It is essential to know the law by which the contracts are governed as well as the jurisdiction in which any disputes are
to be settled. In connection with Greece’s debt restructuring in the spring of 2012, the Greek Parliament decided to amend the laws governing the terms of
Greece’s sovereign debt securities issued under Greek law. As a result of these amendments, 95% of the private investors involved chose to participate even
though it meant that over 55–65% of the current value of debt was slashed. However, the Parliament did not change the currency, even if it could have done
so. It should be pointed out that most of the euro-denominated derivatives in the world economy are governed by the law of England or the State of New York.
After the debt restructuring, the debt contracts in the eurozone governed by the law of England increased in value relative to securities issued under national
law; and now investors demand that English law be applied in dealings with Greece as well.

40 We can refer to the calculation (NExit) regarding the Netherlands’ exit from the euro mentioned at the beginning of the study. The calculation suggests that
NExit would have had hardly any repercussions for the financing and banking system. According to Nordvig’s calculations (2014), the debts and receivables
of the Finnish economy are balanced to the extent the Finland’s exit would not have any significant implications for us. Moreover, while nearly all of Finland’s
sovereign debt is governed by Finnish law, no legal ambiguities as to the payment currency would arise. Finnish companies, too, mostly apply Finnish law in
their euro-denominated commitments.
Where possible, the change of currency would take place during one weekend, possibly by declaring Friday a bank holiday. On Monday, the Finnish markka would be floating and its price would be determined by the market after the initial 1:1 exchange rate.

All cash in circulation would remain euro-denominated without being stamped.

An advance audit would be carried out to assess the ability of the banking system to convert electronic funds into markkas over the weekend and close ATMs at least for the same period of time. As of Monday, all euro-denominated cash withdrawals from ATMs would be debited from markka-denominated accounts at the floating exchange rate.

Since a sizeable percentage of all payment transactions consists of electronic fund transfers, electronic money and euro-denominated cash can be used until the domestic currency has been printed and minted. It would be advisable to make timely preparations for the printing of markka-denominated banknotes. Any loss or damage due to the risk of leaks would not be very significant because the markka would presumably be more or less at par with the euro’s current value.

The powers to prepare the decisions to be taken by Parliament should be delegated to the Government, more precisely to the Prime Minister and the Minister of Finance.

For the political groundwork, Finland would most likely draw support from the other Nordic countries. In these countries, citizens are happy with the decision to retain the national currency. Additionally, Finland should emphasise full cooperation with the European Union, particularly with the ECB officials.

Companies should be assisted in the reinterpretation of contracts governed by foreign law and in related negotiations. Contracts governed by Finnish law can be converted into markkas by a general decision under Lex Monetae.

After the change, Finland should commit to pursue a disciplined financial and monetary policy in accordance with the principles applied by Sweden on its floating currency. It is important that the labour market organisations also show restraint.

Contrary to the scare tactics common in the media, the monetary union could be dissolved in a controlled manner without disrupting the financial markets.

6. The options available for Finland?

In terms of size, Finland is a small member state in the Economic and Monetary Union and its relative weight in the eurozone economy and decision-making is modest, just 1.8% according to the ECB capital key. Identifying and defending the national interests among strong member states is difficult. Contrary to conventional wisdom, a strong Commission is not in the interest of small countries because it is exactly the large southern European countries that greatly influence opinion within the Commission and among EU officials. In a Union with superpower status, large member states make decisions according to their own needs and the small ones follow, even if this is painful for them; this applies equally to foreign policy (to the point of war), internal politics, social policy and labour policy. Even large countries do not always care much for its peripheries if this is not meaningful to the centre.

When asked who supports evolution towards a federation, most Finnish politicians would declare that they are staunchly opposed to it. Of more interest, however, is the fact that so many accept this forceful trend despite their self-proclaimed objection.

By the decisions of Parliament, Finland has committed to a bailout strategy in violation of the Maastricht Treaty 1.0. However, as Finland is not compelled to agree to further violations, Maastricht 2.0 may represent an attractive option to Finnish decision makers. But the monetary union may evolve in a number of directions. It is a further reason why it is important to systematically evaluate all the options open to Finland.
In our opinion, Finland has three main options to choose from:

- Continued involvement in the evolution of the 18 euro members into a federation.
- Withdrawal from the federalist evolutionary process and unilateral return to the Maastricht Treaty while keeping options open as to further developments.
- An immediate exit from the euro.

We will address these options and their implications in the following sections.

6.1 Finland’s Option No. 1: ‘Driftwood’

The ‘driftwood’ option means participation in the federalist evolution and adaptation to the policies determined by the large member states. Finland becomes involved in a process whose outcome it cannot really influence, but which has not been officially approved in a way visible to the citizens. If the policy determined by the EMU decision-makers were no longer to reflect the sound principles based on which the European Union was founded in the 1990s, submission to the role of driftwood would not represent national interest.

The listing of the criteria for a strong federation reveals the conditions that Finland would have to accept, sooner or later. Yet to date, the citizens have not been consulted on these major issues that often directly affect their lives. It is also unclear whether our decision-makers have fully grasped the nature and projected final outcome of the current evolution.

Until a strong federation is in place, the eurozone would, at best, live in the conditions of a weak federation. This would mean slow and confused decision making and the continuation of a vague economic policy. During the evolution towards a strong federation, Finland would have to be prepared for sluggish economic growth, on-going income transfers and declining sovereignty.

As far as Option 1 is concerned, the decisive questions for Finland are how long it would take for the strong federation to emerge and how efficient would it finally be. Let us examine the two extremes of this process: a slowly evolving weak federation and quickly evolving strong federation.

(i) The monetary union remains a weak federation for a very long time

An inflexible and non-innovative Finland with a growing level of debt would basically fit in this type of federation. Finland would not have much to lose in a weak-growth federation, in which a sizeable part of the eurozone would be in dire straits economically. The only triple-A country would be Germany, which would support the other members financially in exchange for sway and influence. Stretched to its extreme, the optimum national strategy of a member in a weak federation could be illustrated with the following imaginary example.

Nordland – a fictitious country and fictitious people in the north

Let us image a country called Nordland. Located in the Arctic region, it has joined a federation founded on the EMU together with peoples living further south. Gold is found in great quantities in the country’s marshlands, its
forests provide an inexhaustible source of raw materials for a growing biofuel industry destined to take over the world market, and its clean-tech companies are busy innovating. Nordland stands to gain substantial tax revenues from mining, its forest assets and other natural resources, which will remain in the country no matter what. Its educational systems produce qualified chemists, biologists and engineers in great numbers. The innovations to be created by these experts will turn them into the heroes of the fourth industrial revolution.

What is the optimum strategy for Nordland's future? One of the options is to collect taxes on the return on the resources to be remitted annually as solidarity-based income transfers to Southland to address the debt problem of the southern parts of the federation on a joint-liability basis. There is also another option for Nordland. As a country with a high credit rating, it could, ostensibly for the purpose of economic stimulation, seek to borrow as much money as possible on the international financial markets and then distribute the funds to its citizens by financing care homes and non-funded elderly services (EUR 700 billion); upgrading all main roads into motorways; repairing all bridges; laying a railway track across Lapland to the Arctic Sea; building a few new airfields in the fell area of Lapland; renovating all mould-infested schools and other properties; excavating undersea tunnels to friendly neighbouring countries; expanding its metro lines to the suburbs and other cities; cutting public expenditure by laying off all tax officials on full salary for a couple of years; and assisting companies in transferring their profits to tax havens. Having accomplished all this, Nordland would inform the international capital markets that it was unable to pay back its debts, but that the federation of the EMU would take care of the loans on a joint liability basis. Luckily, it is all just fiction. Or is it?

SHOULD FINLAND SEEK TO BECOME A NET RECIPIENT INSTEAD OF A NET CONTRIBUTOR IN THE EMU FEDERATION?

(ii) The EMU is expected to evolve into a strong union

Acceding to a strong euro federation would be in Finland’s best interest if we had a strong and thriving economy and wanted to become one of the federal states of Germany. A strong federation would develop democratic decision-making institutions and be a major player in the global economy. Its population, approximately 330 million, would be equal in size to that of the USA. A strong, mature federation could conceivably appreciate experts from even a small nation. However, because of its strong economy, Finland would have to contribute more than the other states on average, which would reduce the benefits of membership.

On the long road to a strong federation, Finland would most likely be compelled to put up with weak economic growth with the accompanying continual increase in income transfers and shrinkage of the sovereignty. It is hard to say to what extent the citizens of Finland would find this line of evolution desirable.

6.2 Finland’s Option No. 2: keeping all options open

As an option, ‘slipstreaming’ means withdrawing from the federalist evolutionary process and returning to the Maastricht Treaty (Maastricht 2.0) unilaterally. At the same time, it leaves the option of pulling out of the euro at a later date.

If preferred, Finland can withdraw from the federalist process and return to the Maastricht Treaty unilaterally. This would mean that as the evolutionary process proceeded in small steps, Finland could at some point decide that it would not participate in the next step, which would represent a sort of threshold. Any decision to withdraw from the federalist process would have to be made by the Finnish Parliament. One benefit offered by this strategy is that it would be possible to pull out of the euro unilaterally at a later date. Such withdrawal would not be without political consequences; however, it would spare Finnish taxpayers from supporting the countries in crisis, such as Greece, in the future. More importantly, Finland would not be involved in the efforts to manage the euro members’ debts on a joint liability basis and it would retain its sovereignty with regard to economic policy. It is worth bearing in mind that those EU member states (Sweden, Denmark, the UK, Lithuania, Poland, the Czech, Romania and
Bulgaria) that are not part of the Eurogroup have not participated in extending credit to Greece, either.

Would Finland need approval from other EMU members and the ECB for the use of the euro in a situation where it would no longer contribute to the joint financing of the countries and banks in crisis? Most likely no country could prevent another country from using its currency as a measure of value and legal tender as long as it did not interfere with the money supply process. For example, the Danish krone is pegged to the euro and Vatican have signed agreements on using the euro. However, for Finnish banks to be able to do remain in the ECB system, it would be necessary, in practice, to agree on the use of the euro and related arrangements. Consequently, the EMU authorities could, if necessary, compel Finland either to accept inclusion as a part of the federation or cease to use the euro as legal tender. If so, the Bank of Finland would manage the relations the way it has done up to the present day. What makes Finland’s choice much easier is that an exit from the euro is not technically complicated.

At the same time, however, the Eurogroup treaties have been drafted in such a way that, for example, any support drawn under the ESM is conditional upon each euro member having incorporated the fiscal compact or the balanced budget act in its national legislation. Finland included this fiscal law in its legislation as of the beginning of 2013. Presumably, all future intergovernmental treaties between euro members will also be combined, making it extremely difficult to stay out of any single agreement. As the Eurogroup treaties are usually drafted and implemented outside the European Parliament, it tends to undermine democracy of the system.

Withdrawal from integration would lead to political solitude (chosen by Sweden and Denmark) but preserve democracy; it would even make it possible to retain the euro if this were felt to be important for trade policy reasons and if the EMU authorities agreed to that. While this could have political consequences and push Finland to the outer perimeter of the EU, it would contribute to economic activity in Finland.

7.3 Finland’s Option No. 3: Fix it, return to the Finnish markka

The third option is a Nordic one – immediate exit from the euro. Before analysing this, we will answer the question whether it is possible to pull out of the euro. Clearly, any individual country can leave the EMU and the euro. The Greeks understood that it would not make sense to leave – at least not before the next tranche of loan.

**IT IS POSSIBLE TO PULL OUT OF THE EURO:**

*In November 2011, the EMU heads of states and governments advised Greece that holding a referendum on the financial aid package would mean an exit from the euro.*

Exit from the euro would mean the re-adoPTION of Finland’s own currency. Nordvig (2014) has calculated that Finland’s financial receivables, investments and debts in the eurozone would not result in any significant financial gains or losses. Of course, the effects would depend on how markets would value the new currency. Based on the data available at the end of 2013, Nordvig estimates that the independent markka would be 7% weaker than the euro. Until the last few years, Finland’s current accounts have been in balance or shown a surplus, and so it would hardly be necessary for Finland to regulate the movement of capital (see Appendix 3). Nor would any significant systemic impacts on capital, credit or derivative markets be anticipated.\(^{42}\)

\(^{41}\) In May, the EMU heads of states and governments advised Greece that a referendum on the financial aid package it had received would mean Greece’s exit from the euro. According to public sources, Italy considered pulling out in 2011.

\(^{42}\) Zettelmeyer, Trebesch and Gulati (2012) have evaluated the systemic impacts of Greece’s debt restructuring in 2012. The exchange of debt securities involved privately held securities worth EUR 205 billion. This reduced the value of receivables from Greece by 55% to 65%, depending on the type of debt concerned. Before the debt restructuring it was estimated that the systemic impact due to derivatives could have been hundreds of billions of euros, which could have led to a systemic crisis akin to that caused by the Lehman Brothers and even to the bankruptcy of the financial institutions issuing the derivatives. In reality, the losses incurred as a result of derivatives amounted to only EUR 2.5 billion, or 2% of the impaired value.
6.4 What options could Finland consider?

Finland will survive in any currency system as long as its economy is sound. Can we then trust our own ability to manage the economy and the country’s public finances? It may be doubted on valid grounds. Our political system is disintegrated. The labour market is dominated by strong unions and the tripartite bargaining system is conservative, effectively blocking the necessary structural reforms.

If we were unwilling or unable to look after the economy well, should we strive to live off the European federation as a silent partner or sink into poverty amidst other counties with a currency of their own? If our decision-makers were unable to pursue a sound economic policy beneficial to the country, should we stay as part of the eurozone in the hope of receiving income transfers? Or should we instead seek to remain outside the euro union in order to allow the floating markka to take care of the necessary adjustments? President Sauli Niinistö reminded us on 15 January 2013 that Finland’s recovery from the slump of the early 1990s was triggered by a 30% fall in the exchange rate.

If we, by contrast, were able to manage the economy well, would it make sense for us to join a joint liability system as a net payer? Would it not be wiser to pull out of the euro? If we stay in the euro, the pressures to amend the labour market system would mount. The weaker the Finnish economy is, the harder these pressures would be.

At present, the EMU countries account only for a little over 30% of Finland’s exports. Contrary to all expectations, this share has fallen since the adoption of the euro. In 2000, nearly 34% of Finland’s exports went to the eurozone whereas the corresponding figure in 2011 was only 31%. Important export markets for Finland are Sweden, the USA, Russia and the UK, none of which is an EMU country.

The democracy deficit in the decision making regarding the eurozone is flagrant. As part of a federation, Finland has been and will be compelled to pay income transfers to other member states and guarantee their debts, which is felt to be unfair. If we were unable to manage the economy well, we would be forced to apply for income transfers from the federation. On what terms would such assistance be provided? Can we be certain that any assistance would be forthcoming in the first place? The EMU includes only a handful of countries capable of providing assistance, which is sorely needed by the countries already in crisis.

CHART 7
Finland’s exports by group of country

It is also advisable for Finland to prepare for the exit of some other member state from the EMU. What implications would this have for Finland?

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43 The fact calls for an explanation why Finnish industry is such a keen supporter of the euro. One explanation could be that if Finland stays in the EMU, a labour reform and further flexibilities in the labour market become necessary. Also, the flagging out of the Finnish industry has intensified since the introduction of the euro. Another point worth noting is that Finland’s accession to the euro was strongly advocated by the trade unions.
Could Finland fare equally well as Sweden after the re-adoption of the markka?

Finland’s industrial base is narrower than Sweden’s. During the previous depression, both the Finnish markka and the Swedish krona had to be devalued by a central decision and later allowed to float. Finland’s position was more difficult because Finland had lost an exceptionally large export sector with the collapse of the Soviet Union. Sweden never received a similar blow. According to the macro theory of the open economy, economic disruptions as well as poor economic policy are reflected in the exchange rate immediately. Each currency finds its own equilibrium on the market on a daily basis irrespective of whether the production base is wide or narrow.

Sweden’s position with its own currency and labour market solutions is better than Finland’s. Moreover, Sweden had carried out most of the necessary political reforms already after the 1990s depression. Consequently, we would be in a tougher situation than Sweden even if we had our own currency. Even so, a national currency would serve Finland’s purposes better than the euro. Finland would have an exchange rate it deserves.

For Finland’s part, there are fears that the inability of our political decision-making machinery to assess the situation and take the necessary policy decisions will, once again, reduce Finnish Parliament and Government to the role of driftwood. Based on the evidence accumulated to date, it is highly likely that the solutions adopted in Finland will be very much paced by the EMU decision-making process. It is not based on the ground rules of democracy. The process seems to proceed so that the proposals put before the Finnish Parliament will consist of individual special measures and regulations prepared by the EU Commission and the Eurogroup officials. Many of them may appear rational and useful in the face of the then-current situation, but in fact nobody will have really assessed the whole package when preparing the specific proposals.

As a result of such a series of isolated decisions, we will end up with a final outcome that the political decision makers of Finland, and those of many other countries for that matter, would not have supported, at least publicly. When the outcome of the process has not been prepared and considered as a whole – unless one is inclined to conspiracy theories – it is more or less doomed to be erroneous and non-optimal. An outcome resulting from this type of process does not rest on a solid foundation.

In the final analysis, Finland’s relationship with the monetary union is determined by the will of the people. Do we want to be part of a superpower or do we want to preserve our right of self-determination? Before making the choice, we need to decide what we want and what we are striving for. If we make the wrong choice, the cost will be high and there will be no easy return. But making the choice is inevitable.

Appendix 1.

The statistical models

Stochastic difference equation:

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64 The undemocratic nature of the European Union has been aptly described by Wahlroos (2012) and Lindblom (2013).

65 In his book The Fall of the Euro, Jens Nordvig of the Nomura Securities investment bank raises justified concerns about the future of the euro. He sees two alternatives to the monetary union: either the monetary union will evolve into a genuine federation or it will be faced with the return to national currencies. Nordvig’s fundamental position is clear, but it pays to look at the federalist option from two angles.

66 The error terms in the models satisfy the so-called conventional assumptions: the expectation value of the error terms is zero, the remainder term variance is constant, and the error terms are non-correlated. When the models are estimated, a sufficiently rich term structure is established to ensure strong enough prediction power. Every effort is also made to ensure that the model would be good enough in terms of its statistical properties from the ‘Hendryan’ point of view.
VAR model:

VARX model (= VAR model complemented with the explanatory variable x):

Appendix 2.

Practical actions to be taken in Finland if the monetary union falls apart

Return to the Finnish markka

In practice, the exit occurs when the central bank announces that it will not exchange any euro-denominated amounts received from abroad at a rate of 1:1. After this, the markets will immediately start pricing the local currency relative to the euro and other currencies, just like what happened when the rouble union and the Czech currency unions fell apart in 1993 (Pomfret 2002; Nordvig 2014).

The external financial position would not become a problem for Finland, either. Finland is able to borrow at a very low rate of interest, and the interest on Finland’s government bonds could even fall because the exit from the eurozone would implicitly also mean withdrawal from potential future joint-liability mechanisms, such as eurobonds and income transfers within the federation. But an opposite course of events is also conceivable, particularly if the reform is made by a weak and irresolute government. A poorly prepared and implemented withdrawal could lead to growing distrust within a short time span.

If the process is controlled, the external value of the Finnish markka would most likely be quite close to the current value of the euro (Nomura’s estimate is –6.8%). Therefore, the euro banknotes in circulation in Finland could be stamped as Finnish currency to be converted into markka banknotes at the same pace as new banknotes are printed. This was the procedure used when the Czech currency union collapsed in 1993 (Fidrmuc et al. 1999; Bootle 2012).

Problems would arise if the new Finnish markka – or other equivalent currency – were to fall sharply against the euro. If so, euros could be withdrawn from circulation because companies and private individuals would not want to exchange their money for a currency that is worth less. Euros could leave circulation also for emotional or practical reasons. A partial withdrawal from circulation of euro-denominated cash would, however, be a minor
problem because in Finland a significant percentage of transactions are made using debit and credit cards or other electronic funds (FK 2008; Leinonen 2007). It would therefore be advisable to retain the cash in circulation as euros.

All the banks and financial institutions would be ordered to convert all the euros into markkas at an exchange rate of 1:1. As a result, all the charge and credit card transactions would be converted into the new currency overnight and all the cash withdrawn from banks would be stamped as the new currency. In reality, a two to three-day bank holiday could be required during which the deposits could be exchanged into markkas and the banks could prepare for stamping the banknotes in circulation. Another alternative would be to apply cash withdrawal limitations for as long as it takes to stamp the money. In case of emergency, all transactions in Finland could probably be effected without cash without causing any major loss or damage to the economy.

The performance of Finland’s banking IT systems should be audited with regard to two things: to determine how quickly euros could be converted into markkas and how euro cash withdrawals could be limited shortly before and after the changeover. The euros withdrawn from ATMs after the changeover would be debited to the accounts at the applicable floating rate of the markka after the weekend when the change is implemented. For the banks, the euro-to-markka conversion could create an open currency position, the risk of which could be minimised with derivatives that the Bank of Finland could possibly enter into with the ECB before implementation.

Usually, the timetable for the measures to be taken prior to a change of currency is problematic. In Finland’s case too, it would be advisable not to give any advance announcement of the adoption of the new currency even if the external value of the parallel currency – the markka – would probably not significantly differ from that of the euro (speculative pressures increase in proportion to the pressures to devalue or revalue the national currency). All the important decisions from the choice of the principles to be applied in the introduction of the national currency to the resolutions to be passed by Parliament should be made over a single weekend. Parliament should give the Government (particularly the Prime Minister and the Minister of Finance) the widest possible powers to implement the currency reform.

Finland is in an optimum position as far the introduction of a national currency is concerned. With southern European countries, the situation is different because their transition would probably require temporary capital controls and long bank holidays.

### Adoption of the markka in Finland

<table>
<thead>
<tr>
<th>Event</th>
<th>Proposed timetable</th>
</tr>
</thead>
<tbody>
<tr>
<td>Determination of the target date for changeover</td>
<td>23–25 May 201X</td>
</tr>
<tr>
<td>Determination of the principles for the adoption of the parallel currency (markka) and debate on an inter-Nordic alternative</td>
<td>23–25 May 201X</td>
</tr>
<tr>
<td>Parliamentary approval and authorisation to Government</td>
<td>23–25 May 201X</td>
</tr>
<tr>
<td>Adoption of parallel currency (markka) in electronic transactions</td>
<td>26 May 201X</td>
</tr>
<tr>
<td>Exchange of banknotes</td>
<td>June–September 201X</td>
</tr>
<tr>
<td>Amendments to the operational principles applied to receivables, debts and programmes under the euro system (e.g. EFSF, ESM, ECB, TARGET2) and definition of Finland’s monetary policy</td>
<td>June 201X–</td>
</tr>
</tbody>
</table>

### The political and economic consequences of adopting a parallel currency

It would be important for Finland to pledge its commitment to the European Union and its laws even after the change of currency. Additionally, Finland should request consultations in all the process phases, particularly with the ECB. Euro-based systems such as TARGET2, EFSF, ESM as well as euro-based contracts, assets and liabilities would adjust to the parallel currency but would require further negotiations.

The Bank of Finland’s ECB position (primarily TARGET2 and the ECB’s Securities Market Programme SMP)
would be converted into Finland’s exchange reserves or receivables from the ECB. Gradually, the Bank of Finland could exchange the euros of this position to other currencies, such as the Swedish krona or US dollar. In January 2014, Finland’s TARGET2 position was EUR 19 billion positive.

Finland is an owner and guarantor of the stability facilities founded by the euro members in Luxembourg. The guarantees will remain in force but the collateral arrangements with Greece will provide protection against potential losses. Consequently, Finland’s risk in respect of the programmes already adopted would remain the same as now as a euro member. When these liabilities mature, Finland would move towards a position similar to that of Sweden, Denmark and Poland; in other words, it would reduce its liabilities for the risks associated with the stability facilities. If necessary, we could also renegotiate the terms of the treaties and agreements. It would be inadvisable to accept any additional liabilities, at least not on the current terms.

Private euro-denominated contracts can be kept in euros until maturity. Alternatively, all the amounts and contracts governed by Finnish law could be converted into markkas forthwith in accordance with the internationally recognised Lex Monetae principle. This situation is made easier by the fact that nearly all of Finland’s sovereign debt securities are governed by Finnish law. Also, a clear majority of companies’ financing agreements and bonds are determined by the law of Finland.

However, it would be important to carefully consider the formation of reference rate curves and the terms of the markka-denominated wages and salaries and bank accounts, and make thorough preparations for the introduction of the new currency. When companies’ contract currencies are changed from euros to markkas, due consideration should be given to commercial and competition issues. Most likely, international investors would probably price Finland’s markka-denominated contracts the same way as Sweden’s equivalent contracts. At present, the State Treasury and municipal debt programmes are not seeking to raise capital in Finland to any significant degree. In the years following the changeover, intense efforts should be made to raise markka-denominated funding in the domestic market in order to enhance liquidity.

Appendix 3.

Redefining the euro (ECU-2)

ECU2 is a solution proposed, among others, by Nordvig (2012) and Miettinen (2012). It would reinstate all the EU’s 28 member states to the position in which they were on 31 December 2008 except that the euro would be retained as the common currency. ECU, the euro’s precursor and the eurozone basket currency, was converted into the euro on 1 January 1999 at an exchange rate of 1:1. In the ECU-2 model, the 18 euro members would adopt a national parallel currency and agree that the existing euros would be defined as the sum total of these 18 currencies. The weights in the sum function would be determined by the ECB’s latest capital key calculated for the euro members.

It would be relatively safe to announce the redefinition of Euro 2.0 in advance and it could be implemented in a controlled manner over a longer period of time without causing a run on the banks in the eurozone on the day of the announcement. The example of the proposed timetable below recommends a swift adoption.

<table>
<thead>
<tr>
<th>Event</th>
<th>Proposed timetable</th>
</tr>
</thead>
<tbody>
<tr>
<td>Advance announcement of the target date for implementation</td>
<td>May 201X</td>
</tr>
</tbody>
</table>

implementation of ECU-2 basket currency (Euro 2.0)
As a result of this low-risk process, the euro would become a basket currency weighted by the ECB’s capital key. It is the same principle as the SDR (Special Drawing Right) applied by the IMF. The euro would continue to serve as a parallel currency side by side with national currencies until all the existing liabilities had expired, which would take decades. The German currency (DEM) would have a weight of 25.7%, the Italian currency (ITL) 17.6% and the Finnish markka (FIM) 1.8%. As these weights are permanent, the redefinition of Euro 2.0 would be a simple arithmetic operation. The new definition would eliminate the interpretative uncertainty associated with the current euro: the breakdown of the euro into national currencies either completely or partially is a possibility that we need to be prepared for. Today, investors do not know if, say, Italy’s euro-denominated liabilities would continue to be honoured in euros in case the euro fell apart or whether part of them would be immediately converted into lira-denominated liabilities of probably lower value. The basket currency model would eliminate this uncertainty already when the announcement is made, which would increase confidence.

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