Euro Crisis, Old and New Trilemmas and Estonia's Position

Alari Purju

School of Economics and Business Administration,
Tallinn University of Technology
Akadeemia tee 3,
Tallinn 12618, Estonia
e-mail: alari.purju@tseba.ttu.ee

Abstract: *The euro crisis created a possibility for the violation, in one way or another, of the one basic condition of the European Union (EU) and the European Monetary Union (EMU)—that each Member State is responsible for the condition of its public debt. This has introduced the need to discuss the next possible steps of adjustment to this new policy request. The old macroeconomic trilemma states that no country can enjoy at the same time free capital flows, stable exchange rates and independent monetary policy and its impact on creation of the monetary policy of the EU is a starting point of the article. Then there is the EU impossibility trilemma, which means that the three general rules of the euro area—that every Member State is responsible for its public debt, there is no co-responsibility of other members of the euro area and the no-monetary financing rule—could not be applicable at the same time. This means that in developing a certain new set of institutions, which are targeting the change of basic general economic policy rules, the regularities of economic activities render only a certain combination of tools effective. The paper discusses the possible choices that are determined by applied arrangements, private and public agents' reactions to them and by the general conditions for policies applied on national and the EU level. The set of possible new regulations will determine the basic features of the EU in the future, though this process may have several possible outcomes. Estonia's position in this discussion and the impact of possible EU level outcomes on Estonia's economic policy is examined.*

Keywords: *EU institutions, Estonian economy, institutional economics*

1. Introduction

The euro is based on three general rules: each Member State is responsible for its public debt, there is no co-responsibility of other members of the euro area, and the no-monetary financing rule.[1] The global economic crisis boosted the public sector deficits on the level that financial markets refused to purchase state securities of countries like Greece, Ireland and Portugal.

In spring 2012, also Spain and Italy had to fight for credibility of credit markets, the state of this fight was reflected in the interest rates of government securities. The possible bankruptcy of these states raised the question of cost benefit analysis of outcomes of the full-level insolvency versus some type of involvement of the EU institutions and other Member States in providing temporary support to these states. The EU Treaty and other regulations do not foresee involvement. The participation of the EU institutions and other Member States in designing respective policy tools and providing funding for them at the same time further develops the EU integration. The theory of optimal currency area (OCA) developed by Mundell, and his well known trilemma, according to which no country can simultaneously enjoy free capital flows, stable exchange rates and independent monetary policy, has been used as a starting point of analysis.[2]

The paper discusses the choice, activated by the euro crisis, combining together the pairs of possible options which are interdependent but at same time not all applicable. The EU impossibility trilemma means that in developing a certain new set of institutions, which are targeting reinterpretation or change of these basic general economic policy rules, the regularities of economic activities render only a certain combination of tools efficient. The possible choices are determined by applied arrangements, private and public agents' reactions to them and by general conditions for policies applied on national and the EU level. The set of possible new regulations will determine the basic features of the EU in the future, though this process may have several possible outcomes. The final part of the article examines Estonia's position in this discussion and the impact of possible EU level outcomes on Estonia's economic policy.

---

[1] EU Treaty Articles 123, 125.

[2] The principles are described in Mundell, 1961; 1963.

2. Mundell–Fleming trilemma, OCA and the creation of euro

The meaning of Mundell's trilemma, according to which no country can simultaneously enjoy free capital flows, fixed exchange rates and independent monetary policy, is that if some state would try to apply these three conditions at the same time, the adjustment of economic agents would eliminate the impact of economic policy measures. If the country, for example, applies free capital flows, then to have independent monetary policy, the country should apply a flexible exchange rate. If there is an OCA, which in this context means that a member of the countries belonging to the OCA has a fixed exchange rate, it has no possibility for exchange rate adjustment. If the country still wants to have an independent economic policy, it should control inward and outward capital flows. If the country applies, as Estonia did quite soon after the introduction of the kroon, free capital flows and a fixed exchange rate, then the country does not have an independent monetary policy and its scope of activities should be limited only to fiscal policy.

In the EU, the vision of common currency was developed from the very beginning as some ultimate goal. The Werner Report was adopted in 1970 and laid out a step-by-step approach to monetary integration with the goal of monetary union in 1980. The members of the European Community (EC) would gradually increase coordination of their economic and fiscal policy, reduce exchange rate fluctuations and, finally, fix their currencies. Two oil shocks and the stagflation of the 1970s made this goal impossible. In 1979, the European Monetary System (EMS), to which all EC countries were members, and optional Exchange Rate Mechanism (ERM)[3] were started. In the framework of Mundell's impossible trinity, the ERM members were looking for exchange rate stability and policy independence with capital controls. Monetary independence meant first of all the possibility for different inflation rates. The next target was to harmonise inflation, which meant to bring it down to the level of country with lowest inflation, which was Germany. The conflict between responsible monetary policy oriented countries such as Germany targeting low inflation and restrictive measures if necessary and more labour market and low unemployment oriented countries such as France made common policy very complicated. The liberalisation of capital markets reduced possibilities for independent monetary policy. The capital controls were formally banned in July 1990. The new

[3] The ERM was the only meaningful part of the EMS and rested on four main elements: a grid of agreed-upon bilateral exchange rates, mutual support, a commitment to joint decision of realignments and the European Currency Unit (ECU); see Baldwin and Wyplosz, 2004, p. 314.

regime with still different inflation levels put pressure on fixed exchange rates on hold. The German reunification brought big extra budget expenditures and fast adjustment of prices and wages in Eastern Germany with an outburst of inflation. The Bundesbank responded to this with a sharp raising of the interest rate. Other ERM members followed the German policy, which was too tight for very many other ERM members. Several countries had to devalue their currencies after spending big amounts of foreign currency reserves on markets defending the exchange rate.

The main lesson of this experience was that although the inflation was successfully reduced among the ERM countries, which is a result of harmonised monetary policy (less independence), the differences between the countries were still big and speculative attacks on currency were possible. The free movement of capital was achieved and the result was that even the reserves of large countries were too small to protect the currency's exchange rate. Monetary integration with separate currencies was realised to be very risky and the monetary union was considered as one option (see also Baldwin & Wyplosz, 2004, pp. 317–322).

The Delors' single market programme framed further monetary integration. This programme was based on Lord Cockfield's 1985 White Paper, which listed 300 measures necessary to transform the common market into the single market. By summer 1987, all members had adopted the Single European Act and the Treaty entered into force. The creation of the European Monetary Union was envisioned to be achieved in ten years, by 1999. This was also planned as a gradual process in three stages towards closed economic cooperation among the EU members with binding constraints on the Member States' budgets and a single currency. The independent European Central Bank (ECB) was designed to be responsible for the EU level monetary policy with the stable price level being the main policy goal.

The OCA theory prescribes characteristics required for a geographic area to obtain maximum economic benefits from using the same currency.[4] The conditions are also vicarious: for example, a flexible labour market would absorb risks related to differences in production. A critical issue is that the OCA should be similar enough to apply similar policy reactions to internal and external shocks. The different production patterns together with rigidities of the labour market were probably the most critical factors why the EU is not the OCA. There are also general fiscal transfers missing; nevertheless, the structural funds' transfers

[4] The general requirements are related to the homogeneity of preferences, production diversification, trade openness, labour mobility, fiscal transfers and communality of destiny; see Baldwin and Wyplosz, 2004, pp. 329–356.

partly fulfilled this function. These circumstances support the critique of authors who underline that the emergence of problems evidenced a dozen years after the start of the euro in 1999 is not an accident or a result of bureaucratic mismanagement but the inevitable consequence of imposing a single currency on a very heterogeneous group of countries, a heterogeneity that includes not only economic structures but also fiscal traditions and social attitudes (Feldstein, 1997; 2011; 2012). Others, like De Grauwe (2003), believed that if all costs and benefits would be taken into account, the balance would be positive.

It could be quite realistic to assume that the EU monetary integration policy was not a result of detailed economic analysis and rigorous realisation of this plan but the outcome of political compromises and geopolitical developments like the German reunification in October 1990. This provided the political push for the Maastricht Treaty. That Treaty laid the legal foundation and detailed design for today's euro area. The political imperative for launching the euro by 1999 required that the political compromises rather than the theoretically unambiguous rules made up the framework for the euro.[5]

The EMU membership criteria were determined by the Maastricht Treaty and consisted of numerical reference values.[6] However, these criteria were softened by the additional interpretations. Article 104c of the Maastricht Treaty stated that countries could exceed the 3 per cent target if "the ratio has declined substantially and continuously and reached the level that comes close to the reference value" or "excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value". The 60 per cent target for public debt was softened by stating that the countries could exceed the limit if "the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace" (*The Maastricht Treaty*, 1992). Bergsten and Kirkegaard (2012) assume that one possible reason for this was that it was politically inconceivable to launch the euro without Italy, the third largest economy in

[5] The OCA theory and the earlier Werner's and Delors' reports had been explicit about the requirements to complement a European monetary union with a European economic union with binding constraints on the member states' behaviour. Political realities in Europe, however, made this goal unattainable within the timeframe dictated by political leaders following the German unification (Bergsten & Kirkegaard, 2012).

[6] The actual reference values to Article 104c of the Maastricht Treaty were in a protocol on the Excessive Deficit Procedure to the Treaty (*The Maastricht Treaty*, 1992). The reference values are 3% limit on general government annual deficit, 60% limit on general government gross debt limit, inflation should be within 1.5% of the three EU countries with lowest inflation, long-term interest rates should be within 2% of three lowest rates in the EU and the country should participate for two years in the ERMII +/- 2.25% band of fluctuation of the currency's exchange rate.

continental Europe, or Belgium, home of the European capital Brussels. Both countries had the debt level of more than 100 per cent of GDP. The fundamental outcome was that the membership of euro was not objectively determined by the fundamental economic strengths of the country, but by political considerations (Bergsten & Kirkegaard, 2012, pp. 3–4). That historical experience plays a role in the positions of participants, negotiating the new set of rules.

The Excessive Deficit Procedure (EDP) based on the Treaty was complemented in 1997 by the Stability and Growth Pact (SGP), which requires the Member States to produce stability or convergence programs (of euro-area Member States and to other Member States, respectively), and to aim at budget positions of close to balance or surplus in the medium term (Korkman, 2005). The SGP was intended to safeguard sound fiscal policy. However, after breaching the 3 per cent deficit limit in 2002–2004, France and Germany pushed through the new interpretation of the SGP rules in March 2005 so that the interpretation of the SGP started to be even more flexible and wholly political (EU, 2005). As Bergsten and Kirkegaard sum up,

> *the euro area by 2005 was, as a result of numerous shortcuts taken to achieve and sustain a political goal, a common currency area consisting of a very dissimilar set of countries without a central fiscal authority, without any credible enforcement of budget discipline and without any real deepening of economic convergence* (Bergsten & Kirkegaard, 2012, p. 4).

The European policymakers' initial denial of problems and optimism was coupled with financial markets' failure to assess the risks related to different euro area countries and reflected by the convergence of state securities' interest rates to the level very close to the German interest rates. The result was that when the crisis hit in 2008–2009, the public and private debt overhang created due to a possibility to finance themselves at very low credits and those not related to economic fundamentals together with the weak EU institutions deepened the crisis even more. This was a starting point for the new challenges the euro area policy-making has to meet when first Greece and afterwards Ireland and Portugal lost access to financial market to finance their government debt.

3. Three general rules and the EU institutions

3.1. No co-responsibility for public debt

The no co-responsibility rule means that each Member State is responsible for its public debt and there is no co-responsibility of other members of the euro area. This principle is known as the "no bailout clause" and fixed in Article 125 of the EU Treaty.[7] The aim of this Article was to declare very clearly from the beginning that the public debt belongs to the respective government and fiscal rules are to be followed. This was also targeting the moral hazardous attitude of governments and market agents. The market-based financing of public debt was foreseen. During the crisis, the unanswered question started to be what happens to the government if it loses access to market. Pisani-Ferry (2012) claims that there are at least three different possible interpretations of the treaty: (1) the country has to restructure its public debt (which could be interpreted as a default in one or another form), (2) the country has to turn to the IMF and be subject to standard procedures for conditional support or, if needed, insolvency, (3) despite the lack of an instrument, the other euro-area Member States would find a way to provide temporary conditional assistance (Pisani-Ferry, 2012, p. 5). As was mentioned above, the market did not differentiate between euro-area borrowers and did not take into account the possibility of default. The Greece, Ireland and Portugal cases forced to look for a clear solution to such problems.

3.2. No-monetary financing

The no-monetary financing condition is stated by Article 123 of the EU Treaty.[8]

The article prohibits direct purchases of the ECB but leaves open the option to

7 The Article says: "The Union shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project. A Member State shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of another Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project".

8 Article 123 states that "Overdraft facilities or any other type of credit facility with the European Central Bank or with the central banks of the Member States (hereinafter referred to as "national central banks") in favour of Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States shall be prohibited, as shall the purchase directly from them by the European Central Bank or national central banks of debt instruments".

buy government bonds on the secondary market. That possibility was first used in buying Greek and Portuguese governments' securities in the framework of Security Markets Programme (SMP) launched first in May 2010. Later in August 2011, the securities of the governments of Italy and Spain were purchased. These purchases formally did not break the law but were indicative of broader monetary policy discussion, especially regarding the separation between the fiscal and monetary policy in the EU.

Pisani-Ferry comments the ECB's decision in the framework of mandate of the ESCB, stated by paragraph 5 of Article 127 of the EU Treaty.[9] According to this comment, the reason given by the ECB for the launch of the SMP was not the preservation of financial stability, but rather the prevention of disruption to the proper transmission of monetary policy decisions.[10] The ECB provided also liquidity to commercial banks initially through short-term debt instrument, but starting from December 2011 the credits up to three years with 1 per cent interest rate were provided. That created also additional source for government debt purchases by commercial banks. This step was also discussed from the point of view of the ECB mandate, what is the price stability.

3.3. Bank–government interdependence

The issue here is that while the euro area is monetarily integrated, banking system is still largely national. States are individually responsible for rescuing banks in their jurisdiction. The critical problem is that some banks—especially if they have more intensive cross-border activities—are very large in comparison with the GDP or tax revenues of a respective state.[11] Banks also purchased public debt. These purchases would not be a threat if the banks portfolios of

[9] Paragraph 5 of Article 127 stipulates the mandate of the ECB to "contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system".

[10] Pisani-Ferry (2012) also argues that several central banks have been given an explicit financial stability mandate and as wholesale securities purchases by the central bank are seen by the market as implicit insurance to the government debt. Central banks generally maintain that they would not preserve the sovereign from funding crisis in case of unsustainable fiscal policy but that they would act to prevent self-fulfilling debt crisis. In comparison with the other central banks, the ECB is a very special type of central bank and is constrained in purchasing of state securities (Pisani-Ferry, 2012).

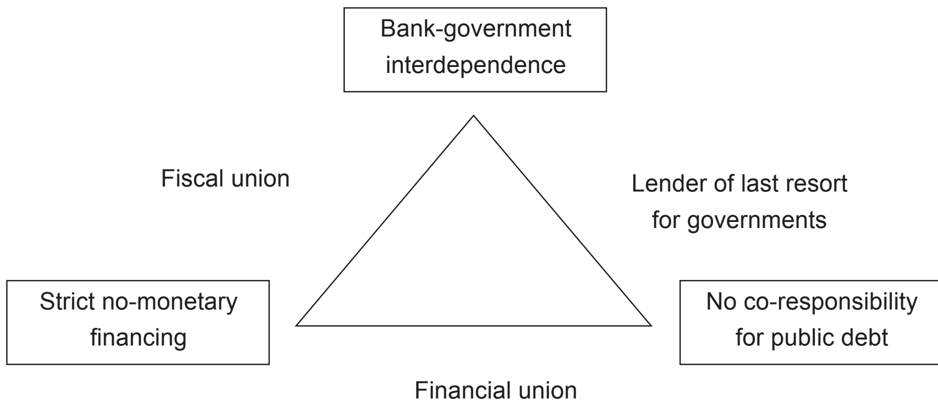
[11] For example, in Ireland, the total banks' assets amounted to 45 times the government tax revenues. Although Ireland had a very low government debt burden before the crisis in 2007 (around 25% of GDP), the banking crisis and the government decision to re-capitalise the banks with public money brought along a full public debt crisis and Ireland has to apply for a support package of the EU and IMF.

government securities were diversified. The problem is that there is still a strong home country bias in these purchases and a respective government having financial problems would be very critical for the banks of this country. In summer 2011, the domestic banks hold the following proportion of the total amount of securities issued by a respective country's government: Spain 28.3 per cent, Italy 27.3 per cent, Germany 22.9 per cent, Portugal 22.4 per cent, Greece 19.4 per cent. That proportion was much lower in Anglo-American countries: in the UK 10 per cent, the USA 2 per cent (Bruegel, cited in Pisani-Ferry, 2012, p. 8).

4. The new trilemma

The coexistence of these three interrelationships describes the basic choices that should be considered in building up a working set of the EU institutions. The components of the trilemma have been described below (see Fig. 1).

Figure 1. The components of the trilemma



Source: Bruegel (Cited from Pisani-Ferry, p. 8)

Pisani-Ferry argues that the impossible trinity renders the euro area fragile because adverse shocks to sovereign solvency tend to interact together with adverse shocks to bank solvency, and because the central bank is constrained in its ability to provide liquidity to the governments in order to avoid the self-fulfilling debt crisis (Pisani-Ferry, 2012, p. 9). In plain English this means that if the government has problems with financing budget deficit then that will become a problem for the commercial banks because part of their revenues

are dependent on interest rate payments and payment received for matured securities. If also the central bank were prohibited from providing liquidity to the system, the result would be the default of the government, but also massive bankruptcy of the banking sector.

The possible EU level solutions would mean the following composition of aggregates.

The fiscal union solution means that there is still no-monetary financing and bank-government interdependence, but the no co-responsibility for the public debt condition is excluded from the system. The fiscal union idea is related to a tighter common fiscal framework and a mutual guarantee of a part of the public debt. The possible eurobonds is one important step in this direction, but that would constitute a complicated trade-off between the influence on the EU level and the country level policy-making. Countries with good credit ratings (such as Germany) would lose economically through distribution of risks with the lower credibility countries. As compensation, they would like to get some control over the fiscal decisions of these lower credibility countries. The EU level response in this direction has been a set of legislative acts based on proposals by the European Commission and adopted by the European Parliament and the European Council on 16 November 2011 and which started to be effective from the beginning of 2012. The new regulations made possible preventive actions against budget deficits, set requirements for the national fiscal frameworks, introduced a 0.5 per cent of GDP limit for public deficit in structural terms and tightened the enforcement through a change in voting rules from consensus to the qualified majority rule.[12] A more substantial problem related to the fiscal union solution is that the EU has very limited tax base for common needs and politically it would be very complicated to adopt solutions which will widen this tax base.[13]

The financial union solution means that there is still no-monetary financing and no co-responsibility for public debt, but bank-government interdependence is

[12] The United Kingdom and the Czech Republic decided to stay out of this regulation which made it impossible for these countries to adopt it in the form of a treaty. It was adopted as an intergovernmental agreement.

[13] "European institutions do not rest on the same degree of direct democratic legitimacy as the US federal government. Crucially, this makes the collection of direct taxes to fund a large centralized European budget (similar to the US federal budget) politically impossible. The relatively high willingness of Europeans to pay taxes does not "extend to Brussels". The designers of the euro area were consequently compelled to create the common currency area without a sizable central fiscal authority that would have the ability to counter region-specific (asymmetric) economic shocks, or re-instill confidence through the deployment of large fiscal resources to private participants in the midst of a crisis" (Bergsten & Kirkegaard, 2012, p. 3).

excluded. The EU level financial mechanisms would use respective instruments to handle problems should they emerge. That solution would assume the EU level supervision and inspection of the European banks. Pisani-Ferry's argument is that such reforms amount to fundamental transformation of the mostly bank-based financial systems of the euro area, where the government bonds have been considered as an ultimate safe asset for respective country's banks. Diversification of the banks' portfolios of government securities would make the default of one government less vulnerable for the banking system (Pisani-Ferry, 2012, p. 11). The second aspect of this problem is related to the European-level rescue schemes solving in this way the mismatch between tax revenues of a respective country versus the state's potential responsibilities in the case of banking crisis. The proposal is to create the European-level fiscal capacity with assigning to the European Financial Stability Facility (EFSF) the responsibility for backstopping the national deposit insurance schemes and to create a permanent European Deposit Insurance Corporation financed by banks (Véron, 2011). The euro area levy taxes with the limit of 1 or 2 per cent of the GDP are proposed to finance this solution (Marzinotto, Sapir & Wolff, 2011).

The lender-of-last-resort solution for government means that there is still bank-government interdependence and no co-responsibility for public debt, but the ECB will be given the role of lender-of-last-resort for governments. This solution means that the ECB could lend to a government for a limited period at a rate that is above the risk-free interest rate but below the market interest rate or could provide the credit line to the public entity (for example the EFCF) (Gros & Mayer, 2011). This proposal has been intensively discussed and has been seen by several commentators as a single credible solution to the euro area crisis.[14] The resistance of Germany to this solution has been crucial. This would be against the basic conditions, which framed the foundations of the ECB.[15]

[14] Nouriel Roubini argues that "the ECB should not just stop rake hiking, it should cut rates to zero and make big purchases of government bonds to prevent Italy or Spain losing market access—the outcome of which would be a truly major crisis" (Roubini, 2011). Wolfgang Münchau states: "The ruling leaves the post-Stark ECB as the sole backstop that could prevent a break-up of the eurozone" (Münchau, 2011a; 2011b).

[15] The US Federal Reserve is quite different in these terms. The commercial banks in the USA hold very little federal debt, the Reserve would be able to intervene to avoid the federal government losing access to markets and the federal government, not the state governments, is responsible for rescuing the banks. The Troubled Asset Relief Program (TARP) was passed in close cooperation of the US Treasury, Federal Reserve and the Federal Deposit Insurance Corporation and stabilised the situation after the critical period of September–October 2008 in March 2009 (Bergsten & Kirkegaard, 2012; Pisani-Ferry, 2012).

Another imminent problem is the moral hazard phenomenon closely connected to interrelationships between the additional funding available for markets reflected in prices of government securities and the willingness of governments to initiate necessary reforms. This has been also closely related to the bargain between the ECB and the euro-area governments about the responsibility of one or another participant in dealing with the crisis.[16]

5. Steps up to this day, interpretations and probable outcomes

5.1. A short overview of steps

The EU could provide assistance to the Member State in extreme circumstances. The European Council could then take a respective decision proposed by the European Commission (EU Treaty, Art. 122, § 2). During the economic crisis, which started in 2008–2009, several institutions were used and created to deal with the problems. The European Financial Stability Mechanism (EFSM) has the financial capacity of up to 60 billion euros, the loans are provided under the condition that the EU and the IMF are supporting the loan program. The EFSM funding comes from the EU budget and is targeting financial stabilisation. The EFSM has borrowed 22.5 billion euros to Ireland and 26 billion euros to Portugal at the end of 2011.

The Greece Loan Facility (GLF) was created in May 2010 with the total capacity of 110 billion euros, 80 billion euros being the EU support and 30 billion euros came from the IMF. The Facility covers financial resources paid out by Member States on the basis of bilateral agreements with Greece.

The European Financial Facility (EFSF) was founded in May 2010. It is a private agency which provides loans under economic policy programs, adopted by the respective borrowing countries. The EU governments guarantee the EFSF liabilities up to 780 billion euros and the Facility could provide loans up to 440 billion euros (EFSF, 2012). The EFSF emits long-term securities and finances governments from money borrowed from markets. The liabilities related to the first Greece package and supported by the GLF were transformed into the EFSF as a second loan package to Greece. Also credits to Ireland and Portugal are paid out from the EFSF.

[16] Bergsten and Kirkegaard (2012) sum up the process on the example of the initial Greek crisis in May 2010: The ECB agreed to set up the Securities Market Program to purchase from secondary market the governments' securities and euro area governments produced the 440 billion euro EFSF in resources to deal with the crisis. This agreement produced strong commitments for structural reforms in Spain and other states.

The European Stability Mechanism (ESM) was founded in October 2010 and is a permanent mechanism which will start to operate in the middle of 2012 and will take over liabilities of the EFSF. The Member States have to purchase their share in five years and the total amount of the capital of the ESM will be 80 billion euros. The ESM total loan capacity will be 500 billion euros. The resources would be purchased from financial markets for emitted securities.

The ECB founded the Security Markets Programme (SMP) in May 2010 and started to purchase from secondary market first the Greece and Portugal governments' securities and later in August 2011 also the securities of the governments of Italy and Spain. In December 2011 and late February of 2012, the ECB provided in the framework of Longer-Term Refinancing Operation (LTRO) 1.2 trillion euros as three year loans to commercial banks. The funding was widely used by banks to purchase domestic government securities and was called "backdoor quantitative easing". There is a threat that due to this program pressures on governments for fiscal and structural reforms and for banks to restructure their balance sheets has lessened (Milne, 2012).[17] Euro-area inflation stayed at 2.6 per cent in February and March 2012, well above the 2.0 per cent target level.

In November 2011, a set of five regulations and one directive ("Six Pack") was proposed by the European Commission and adopted by the European Parliament (EC, 2012).

The new legislation became effective as of 1 January 2012. The new legislation introduced preventive actions about fiscal deficits, set minimum requirements for national fiscal frameworks, toughened sanctions against countries in excessive deficit and tightened enforcement by a change in the voting procedure. Other important changes in regulation were the following: adopted newer rules on balanced budgets in structural terms, based national budgets on independent forecasts and for countries in excessive deficit procedure, and allowed examination of draft budgets by the European Commission before they are adopted by the parliaments. Afterwards, the European Commission proposed

[17] "While banks have used the money for a variety of purposes including refinancing their debt, they have also clearly stocked up on state paper. Spanish banks, for example, increased their holdings of Madrid's state bonds by 29 per cent in December 2011 and January 2012 to reach 230 billion euros, Italian banks boosted their domestic purchases by 13 per cent over the same period to 280 billion euros [...] Under the so-called carry trade, banks get the money at 1 per cent from the ECB and invest in higher-yielding securities. Two-year yields for Italy have fallen from 4.6 per cent to 2.5 per cent and for Spain from 3.4 per cent to 2.5 per cent so far this year [the end of March 2012]"(Milne, 2012).

a new legislation that requires the Member States to give the Commission the right to assess and request revisions to draft national budgets before they are adopted by the parliament. In December 2011, the EU heads of states committed themselves to introduction of fiscal rules, stipulating that the general government deficit must not exceed 0.5 per cent of the GDP in structural terms, that the new treaty would allow automatic sanctions for countries whose budget deficits are over 3 per cent of the GDP limit. Sanctions are recommended by the European Commission and will be adopted unless a qualified majority of euro-area Member States is opposed (Pisani-Ferry, 2012, p. 2).

The Treaty on Stability, Coordination and Governance (TSCG) is an agreement of the heads of states on Euro Summit from 9 December 2011 and will be adopted if all national parliaments will ratify the agreement (the United Kingdom and the Czech Republic are left out). The European Stability Mechanism (ESM) Treaty was agreed on same summit and will be also adopted when the euro-area parliaments will ratify the treaty (EC, 2011).

5.2. Interpretations

The interpretation could be separated to short- and long-term parts. In short term, the governance structures have been improved by very fast actions dictated by developments on financial markets, rapidly changing negotiation conditions and political events in particular countries. Pisani-Ferry, Sapir and Wolff (2012) examine in their recent paper how the new regulations (six-pack and two-pack regulations and two agreements) have made the decision-making much more complex. Also they underline that the gap between the euro area and non-euro area would widen while all these new regulations would be adopted. Their examples are the following:

1) The Stability and Growth Pact (SGP) in principle applies to all 27 EU members. However, sanctions are foreseen only for euro-area members. Only euro-area members can vote on Excessive Deficit Procedures' (EDP's) steps that involve only euro-area members;
2) Most of the so-called Six-Pack Reforms are based on the Lisbon Treaty and make a clear distinction between the euro area and non-euro area. In particular, Regulation 1176/2011 on the prevention and correction of macroeconomic imbalances applies to the whole EU but the alert mechanism, which is part of the regulation, is, in accordance with the paragraph 3 of Article 121 of the new TFEU, discussed in the euro group for the euro-area countries. Also the so-called Scoreboard, which forms the basis of the alert mechanism, distinguishes between euro area and non-euro area, etc.;

3) The Treaty on Stability, Coordination and Governance (TSCG) has two main elements: the so-called Fiscal Compact, which requires the main elements of the SGP to be transposed into national legislation at a constitutional or equivalent level and establishes the regular Euro Summits. The new treaty renders the tension between the national sovereignty and the logic of supranational intervention clearly visible. Overall they conclude that the EU can be characterised by an increasing legal, institutional and policy divide between the euro area and non-euro area, increasing variable geometry blurring the euro area and non-euro area distinction, high complexity and lack of clarity and increasing tensions between the demands of national sovereignty and euro-area sovereignty.

5.3. Probable outcomes

The financial crisis has forced the EU institutions to apply emergency measures, which have been limited by the existing legal framework; also, the loopholes and borders of several regulations have been examined. Parallel to this the new regulatory instruments have been developed. These new instruments have been worked out sometimes ad hoc, very often as compromises following severe political discussion and under immense pressure of financial markets. At the same time these instruments reflect on a very basic level threats and expectations of different governments participating in this process.

In terms of the trilemma discussed above, the solutions target fiscal union and financial union type of the EU. In short-term, however, the crisis management issues are on the table and the outcomes depend heavily on domestic debates and cost-benefit analysis from the donors' side, in terms of how much additional resources would be needed, and from the receivers' side, in terms of how many reforms they are ready to apply and how much loss of national sovereignty is acceptable for the public.

Pisani-Ferry, Sapir and Wolff (2012) designed three scenarios: (1) A two-speed EU, with a coherent euro area; (2) A fragmented EU, with fragmentation even within the euro area; (3) A generalised variable geometry even within the euro area. Only the first scenario develops the EU integration further, leaving out the non-euro members of the EU. This scenario would apply that the euro area evolves from a monetary union with some fiscal rules to a full-fledged monetary union with a fiscal and banking union. It would have a strong, democratic political centre able to impose on national budgetary decisions, a federal budget with direct access to tax resources providing some degree of stabilisation to the national entities and a public debt management capacity. It would also have

a banking supervisor, a banking deposit insurance mechanism and a banking resolution agency. It will also apply that the euro area becomes de facto a political union. That would provide a smaller EU (Marzinotto, Sapir & Wolff, 2011). This means, first of all, financial union type of integration and is, of course, a possible long-term development. Other two scenarios would bring along in one form or another the marginalisation of the EU as a whole and respective policy agendas will be taken over by the leadership of large Member States, probably becoming the local centres for its satellites.

6. Estonia's position

Estonia is a small open economy and influenced by external developments. Estonia's pre-crisis boom was a source of great concern at consolidation steps and afterwards brought along deep economic decline and large-scale unemployment. The consolidation measures, however, were in line with the respective EU policy targets, first of all fixed in the SGP. Estonia's GDP growth was 7.6 per cent in 2011 and is expected to be 1.7 per cent in 2012 after a 17.5 per cent decline during 2008–2009. The unemployment rate increased from 5.7 per cent in 2008 to 14.4 per cent in 2009 and to 17.6 per cent in 2010 and amend down to 12.9 per cent in 2011. The budget deficit is expected to be 2.6 per cent in 2012.

Estonia's general position regarding the EU declares that Estonia is interested in the strong EU which is open and developing, Estonia is interested in bringing a new area under competence of the EU and in deepening the already existing EU competences. Estonia is interested in strengthening the euro area, the common financial market and competitiveness of the EU.

Economic and financial policy of the EU should be sustainable and the Member States should fulfil the requirement of the SGP (*Estonia's European Union Policy 2011–2015*, 2011). Estonia ratified the EFSF agreement in the parliament without painful political discussion, although the Minister of Finance Jürgen Ligi had to answer questions regarding Estonia's liabilities in the case of realisation of the worst scenarios. Estonia does not participate in the Greece Loan Facility because Estonia joined the EMU only at the beginning of 2011.

Estonia is looking forward to that the budgetary rule introduced by fiscal compact will support the achievement of EU priorities. Estonia is preparing the ratification of the ESM and the fiscal treaty (submission to Parliament in May

2012 as well as the introduction of the fiscal rule in budget framework law (Ligi, 2012).[18]

The EU Estonia's officials have been quite cautious in expressing political positions regarding Estonia's priorities regarding one or another potential development pattern of the EU. In an interview to the *Riigikogu Toimetised* (in English *The Journal of Estonian Parliament*), Ligi was very critical regarding the possibility that the EU would purchase government securities and abolished Estonia's support to the EU based lender-of-last-resort for governments. The strict no co-responsibility for public debt and restrictive measures for the Member States who cannot finance their public debt and are not able to balance their budgets, is also a position of current Estonia's government. Regarding the possibility of a fiscal union, the position is that the political steps in deepening cooperation in fiscal matters are welcomed, but the closer future fiscal integration is a long-run issue. If the possibility of fiscal union is discussed, then the position has been that the EU tax system is uncompetitive and Estonia is interested in sustaining its tax system, which is very strongly biased toward indirect taxes, there is a proportional income tax and retained corporate profits are taxed with zero per cent corporate income tax. At the same time, Estonia is interested in harmonisation of rules for value-added tax and excise tax (elimination of exceptions) and some kind of harmonised tax base for corporate income tax, operating on the EU market (Tupits, Bahovski & Ligi, 2011). Estonia, Sweden, Finland and Luxembourg were at the end of 2011 the only members of the EU to which the European Commission had not started the Excessive Deficit Procedure.

7. Conclusions

The trilemmas examined in the article mainly describe parameters related to fiscal and monetary policy and their impact on framing the future of the EU. The short-term financial crisis targeting measures and long-term design of the EU is overlapped and complicates the picture. It could be assumed that if adopted by the national parliaments, especially decisions taken by heads of governments on 9 December 2011 would develop the fiscal integration of the EU. At the same time, several authors (the Bruegel scenarios) emphasise that the new regulations increase the gap between the euro area and non-euro area members. The

[18] In the last week of April 2012, Estonia's Chancellor of Justice raised the question about the conformity of the ESM to the Estonia's Constitution. The Supreme Court of the Republic of Estonia is supposed to discuss the issue during the spring of 2012.

outcomes depend heavily on domestic debates and cost-benefit analysis from the donors' side, in terms of how many additional resources would be needed, and from the receivers' side, in terms of how many reforms they are ready to apply and how much loss of national sovereignty is acceptable for the public. The development toward fiscal and financial union could be considered possible, but at the same time the number of states which would be ready for deeper integration is open. The regulatory framework between the groups of countries with different level of integration is a big question mark. The discussion did not cover directly structural reforms, which are crucial for long-term sustainability of the euro area, and the EU. Estonia's position demonstrated the attitude of an EU and EMU member who has been rigorously fulfilling the SGP requirements. Supporting integration in the name of a deeper and wider common EU market, the country is interested in some harmonisation of the fiscal area but is eager to sustain some specific features of its tax system.

References

Baldwin, R. & Wyplosz, C. (2004), *The Economics of European Integration*, Berkshire: McGraw-Hill Companies.

Bergsten, C. F. & Kirkegaard, J. F. (2012), 'The Coming Resolution of the European Crisis,' *Policy Brief*, January 2012, no. PB12-1.

De Grauwe, P. (2003), *The Economics of Monetary Union*, 5th Edition, Oxford: Oxford University Press.

EC (2011), *Statement by the Euro Area Heads of State or Government*, Brussels: European Commission, 9 December 2011.

—— (2012), 'Six-pack? Two-pack? Fiscal compact? A short guide to the new EU fiscal governance,' *Economic and Financial Affairs*. Retrieved from http://ec.europa.eu/economy_finance/articles/governance/2012-03-14_six_pack_en.htm [accessed Apr 2012]

Estonia's European Union Policy 2011–2015 (2011), Tallinn: Government of Estonia.

EU (2005), EU Council Conclusions, 23 March 2005, Retrieved from http://www.consilium. Europa.eu/uedocs/cms_data/docs/pressdata/en/ec/84335.pdf [accessed Apr 2012]

European Financial Facility (2012), [homepage] Retrieved from http://www.efsf.europa.eu [accessed 20 Apr 2012].

Excessive Deficit Procedure (1992), Retrieved from http://eurotreaties.com/maastrichtprotocols.pdf [accessed Apr 2012]

Feldstein, M. S. (1997), 'The Political Economy of the European Economic and

Monetary Union: Political Sources of an Economic Liability,' *The Journal of Economic Perspectives*, vol. 11, no. 4, pp. 23–42.

—— (2011), 'The Euro and European Economic Conditions,' *NBER Working Paper,* no. 17161, November 2011.

—— (2012), "The Failure of the Euro: The Little Currency That Couldn't," *Foreign Affairs*, vol. 91, no. 1, pp. 105–116.

Gros, D. & Mayer, T. (2011), 'Refinancing the EFSF via the ECB,' *CEPS Commentary*, pp. 1–8.

Korkman, S. (2005), *Economic Policy in the European Union*, Basingstoke & New York: Palgrave MacMillan.

Ligi, J. (2012), "Estonia's Views on the Efforts to Deal with the Sovereign Debt Crisis in the Eurozone," Minister Jürgen Ligi's speech in the Royal Danish Embassy in Tallinn, 17 April 2012.

Marzinotto, B.; Sapir, A. & Wolff, G. B. (2011), 'What Kind of Fiscal Union?' *Bruegel Policy Brief*, 2011/06, November 2011.

Milne, R. (2012), 'A Leaning Tower of Perils,' *Financial Times*, 28 March 2012.

Münchau, W. (2011a), 'Stop rejoicing. This was no victory for the eurozone,' *Financial Times*, 11 September 2011.

—— (2011b), 'Eurobonds and a fiscal union are the only way out,' *Financial Times*, 18 September 2011.

Mundell, R. A. (1961), 'A Theory of Optimum Currency Areas,' *The American Economic Review*, vol. 51, no. 4, pp. 657–665.

—— (1963), 'Capital Mobility and Stabilization Policy under Fixed and Flexible Exchange Rates,' *The Canadian Journal of Economic and Political Science*, vol. 29, no. 4, pp. 475–485.

Pisani-Ferry, J. (2012), 'The Euro Crisis and the New Impossible Trinity,' *Bruegel Policy Contribution*, 2012/01, January 2012.

Pisani-Ferry, J.; Sapir, A. & Wolff, G. B. (2012), 'The Messy Rebuilding of Europe,' *Bruegel Policy Brief*, 2012/01, March 2012.

Roubini, N. (2011), 'Mission impossible: stop another recession,' *Financial Times*, 7 August 2011.

The Maastricht Treaty (1992), Retrieved from http://eurotreaties.com/maastrichtec.pdf [accessed Apr 2012].

Tupits, A.; Bahovski, E. & Ligi, J. (2011), 'Euroopa Liidu võlakriis – kas majandus- või poliitiline kriis,' [in Estonian] (The Credit Crisis of the EU–Economic or Political Crisis?) A round table discussion with A. Tupits, E. Bahovski, J. Ligi. *Riigikogu Toimetised*, vol. 24, pp. 21–30.

Véron, N. (2011), 'Testimony on the European Debt and Financial Crisis,' *Bruegel Policy Contribution*, 2011/11, September 2011.