EAST-WEST
Journal of **Economics and Business**
Vol. XVI – 2013, No 2

Economic Risk Transmission in Europe between the Center and the Periphery: A Theoretical Approach

Gildas BONDI
CRIISEA, Université de Picardie Jules Verne, Amiens

Nikolay NENOVSKY[4]
CRIISEA, Université de Picardie Jules Verne, Amiens
University of National and World Economy, Sofia IGERIA

ABSTRACT

Our main hypothesis is that the stylised division of the EU in sub-sets is largely endogenous and internal to the integration processes themselves. Given the genesis and the designed functioning of the EU and the Euro-zone, a set of centrifugal processes come into play inevitably leading to disintegration. The self-propelled breakdown processes come through the creation of "an illusory impression" of safety net and risk insurance in all sub-sets of the EU. This not only increases the overall level of risk and vulnerability but also leads to unfavourable risk redistribution directing it to the weaker links in the whole EU structure. The economic system then becomes much more vulnerable to not only external shocks but also to internal ones. This is usually accompanied by loss of discipline and the emergence of various forms of non-market and bandit behaviour in all sub-sets.

Keywords: Euro-crisis, European integration, endogenous instability, EU enlargement

[4] Corresponding author, nenovsky@gmail.com.

JEL Classification: F33, F36, P20, P30

Introduction

In the very eve of the 1929 Great Depression, the French economist and journalist Francis Delaisi published a book with the eloquent title Les deux Europes [*The two Europes*, 1929][5] where he uses the metaphor of a traveler flying over Europe and carefully studying it. Two extremely opposite parts of Europe appear before his eyes. Europe A is that of the countries at the core of the European economy, while Europe B is represented by the southern, peripheral countries. Whereas Europe A is an industrial economy, having embraced technological progress and is culturally flourishing and democratically advanced, Europe B is a backward agrarian zone remaining technically very rudimentary - not to say primitive - being averse to technical progress and ruled by corrupt and autocratic governments. Furthermore, while Europe A (E1) saves and invests, Europe B (E2) spends, lives for the day and runs into debt with E1. Ultimately, the E2 economic agents incur huge debts, both external and internal, which put to threat the position of E1 creditor-countries.

Ever since Delaisi time, European countries and Europe as a whole have made a significant technical, economic and social progress from competing colonial powers surrounded by mediocre periphery into a set of cooperating and integrated economies with high institutional standards. Over the last two decades the pace of European integration has increased even more with the collapse of the communist bloc and the accession of most of the East European countries to EU membership. The perception of economic advancement and progress of the integration and harmonization processes in Europe however was harshly chilled with the advent of the global crisis. Hence "the ghost" of the two Europes Delaisi wrote about more than 80 years ago appears once again. Those two parts of Europe have visibly split from each other and one can easily admit that behind its strong and solid surface the European project is a rather fragile and uncertain feature. Moreover it is argued that as it presently stands the overall European project is genetically fated to divide Europe into two or more Europes and to ultimately endogenously destroy itself.

[5] At the time Delaisi wrote his book, the above mentioned division of Europe into part A and part B was popular enough (see for instance Batou [2000]). At the time of the Great Depression, possible ways of helping South Europe, *i.e.* Europe B, were internationally discussed as it suffered from the abrupt decline in prices of agricultural goods ruining those countries' balance of payments and jeopardising the servicing of external debt. The so-called "Agrarian bloc" was offered different measures such as export subsidies, currency devaluation, sharp increase in money supply, etc. See Bonnet (1933) and Nenovsky (2012).

Clearly, the contemporary division of Europe has its peculiarities, but on the whole it reminds of what Delaisi once witnessed. The core E1 is basically represented by the countries from Northern Europe standing close to Germany and having "German economic way of thinking". The E1 countries follow different macroeconomic and behavioural trajectories from E2, which is composed of South-European economies and the majority of former socialist countries. Whereas the E1 countries (despite the general trend of deindustrialisation in Europe) try to maintain their industrial development, preserve their competitiveness, keep satisfactory rates of savings and capital accumulation, and sound public finances, in E2 economies (often called peripherals) quite the opposite can be observed – industrialisation, technologies and innovations lag behind, consumption explodes, savings are extremely low and private and public debt grow considerably. Just as in the years before the Great Depression, the E2 countries today attract savings and capitals from E1 countries. This way they are not only worsening their current accounts but are stimulating the growth of various debt bubbles, real estate credit in particular. This results in a temporary and artificial economic growth.

Also, definite parallels between the monetary regimes from the 1929 period and the ones run today can be established. In the late 1920s most countries were under a regime of partially restored gold standard (gold-exchange standard). This restoration took place in mid and late 1920. Today, most European countries share a common currency and a common European Central Bank (ECB), while the rest follow the ECB's policy either by a fixed exchange rate (or Currency boards) or inflation targeting.

At a whole, the above line of reasoning shows the existence of two archetypal and opposite models of development across Europe (E1 and E2) although an obvious number of specificities and subgroups could be identified within E1 and E2[6]. Hence, the basic task of this article is to construct a theoretical framework which highlights the mechanisms whereby the process of European integration - as is currently observed - leads to the emergence of sub-sets within Europe.

The main hypothesis we put forward is the following: the genesis and operation of the European Union and the Euro-zone are such that they generate internal processes, endogenous for both systems, which in turn inevitably lead to self-disintegration[7]. More generally, these self-propelled breakdown processes come through the creation of "an illusionary impression" of a safety net in the system

[6] We leave aside the discussion of the diversity of forms of capitalism, transitional economies and even economic systems which have gained high popularity in recent years, see among others Amable (2005), Csaba (2007), and Farkas (2011).

[7] Among the few studies on disintegration theory are the old study of Röpke (1942) and more recently Slim (1997).

and its risk insurance. This in turn not only raises the overall level of risk and vulnerability in the EU but also leads to unfavourable redistribution of the risk, directing it to weaker links in the system. Hence, this is accompanied by a loss of fiscal and financial discipline and the emergence of various forms of non-market and bandit behaviour in both E1 and E2. The system becomes much more vulnerable not only to external shocks, but also to its own, i.e. internal ones.

The above-described processes of course are not purposely designed. Rather, they are manifestation of the law of "unintended consequences" of political and macroeconomic decisions. In this sense, the self-disintegration is a logical outcome of the rational behaviour and strategies of economic actors[8]. The purpose of this study is to show what these processes are about, what the consequences of their underestimation could be, and what would be appropriate to do under the current situation[9].

Hereinafter the study is organized as follows: firstly, the general logic of the model is given whereby the EU and Euro-zone's institutional and political structure itself generates various forms of collateral (we could also use the terms guarantee or insurance) in different parts of the system, thereby sharply raising the risk-behaviour level in general and in some individual segments of the system in particular. The next part suggests one linear formalisation of the model. The third part analyses the forms of collateral or insurance: explicit – say evident – or implicit and presumed, virtual. The transmission channels of risk behaviour are discussed and elaborated. Finally, we suggest some ideas for possible policies to follow in the current situation and some scenarios of future revisions of the European project basically towards counteracting and safeguarding against the emergence of the insurance game and moral hazard.

[8] Similar behavioural self-disintegration processes were observed in the functioning of the socialist integration, as well as within the individual planned economies, especially during the last phases of breakdown of those systems.

[9] The theories of optimal monetary zones, convergence and catching up are useful and give a range of ideas; however the issue here is more about clarifying the transmission mechanisms of breakdown in a situation of misconception of the processes of integration and above all of the mechanism of growing risk behaviour and loss of discipline. Of course, a number of assertions about the optimality of a given zone remain valid, be it with reference to the classical theory of optimal zones, which is static by nature, or to the theory of endogenous zones. Just as the classical theory of monetary zones fail to or insufficiently examine the breakdown processes of the zones already created and their manifestations, so too do the new trends (see recently Mongelli, 2013). The model proposed below shares some features in common with the theory of internal instability of the financial system, as promoted by Minsky, and a number of elements of the Austrian theory of the economic cycle.

Presentation of EU insurance model

The current form of integration in Europe could be brought down to the following analytical cause-consequence chain.

The starting point is the concomitant launching of the European project for enlargement and the adoption of a single currency which brings into existence the "European anchor" as a major institutional mechanism coordinating expectations and behaviour of economic and political actors. This anchor in turn leads to the sudden and imperceptible emergence of an ex nihilo guarantee or an insurance fund (hereinafter referred to as Φ) which diminishes the perception of risk and creates a sense of security by presenting a kind of virtual subsidy. In other words, the European project – which intends to promote a tight and sound financial discipline – becomes the initial impulse to loosen the budget constraints of economic agents. The risk-behaviour therefore quickly heightens deforming in turn the basic incentives for consumption investment and savings. Hence, a range of bandit and crony strategies appear. Consequently, after some latent period, the overall production structure becomes deformed and the system inevitably falls apart from within[10]. This calls for a clearer *exposé* of the dynamics of self-disintegration.

Assuming that the goal of the European project for enlargement has a strong moral and rational ground and is at least at first sight logically sound, one can summarise the task of EU-member and candidate countries as to unite into a common and integrated market and through the mechanisms of the single currency and the single monetary policy. In addition, through the set of statutory criteria of fiscal stability nominal convergence, etc. they aim to overcome the centuries-old political, economic and cultural antagonisms. It stands on the presumption that through a range of economic mechanisms described by the now classic theories of international trade and integration unions, the relatively poorer zones in E2 will catch up with the richer ones of E1. This would mainly take place through the processes of convergence and movement of production factors, goods and services. Thus, for instance, capital would move towards the zones where its marginal efficiency is higher, *i.e.*, to E2, and labour force to E1 where salaries are higher. However the European project has never totally relied on market forces and the re-distributional processes, through the various kinds of European funds, have always been leading this integration. The role of the State and the importance and

[10] The model below can be viewed as a form of the well-known mechanisms of asymmetry of information, unfavourable choice, moral hazard and incomplete contracts; here however we are striving to give a broader and, in a sense, sociological perspective to the issues of risky behaviour.

significance of the European social model have been stressed many times in all major European documents and resolutions.

We argue that the models of the European Union and the Euro-zone automatically trigger the appearance of a number of public and supranational guarantees and insurances which form a kind of a guarantee or insurance fund (referred to as Φ), which dulls the sense of risk and increases the illusion of safety for the various actors, thus spoiling economic discipline. This guarantee fund Φ, whose components will be discussed below, considerably increases the level of risk in the EU and the Euro-zone while blunting the sense of risk and uncertainty through various mechanisms. Overall, the risk premium and the cost of assuming risk no longer reflect its actual level. The consequent underestimation of risk leads to the appearance of a free insurance or hidden subsidy or artificial, institutionally induced guarantee equal to ($-\varphi$) where φ is the risk premium. This subsidy in turn increases the explicit - say perceived - real interest spread between E2 and E1. The free insurance ($-\varphi$), through the increased perceived real interest rate, is crucially important to E2 countries which rely not only on internal, domestic bail-out mechanisms, but also on the guarantees of the European Union and hence those of E1 countries.

On the whole, in E2 the price of risk becomes considerably lower than it would have been, had the countries from that group not been members of the EU and of the Euro-zone eventually. One can call this the "EU-accession premium" as it applies to EU candidate countries whose accession is in progress or to new-member states. It justifies the flow of savings from E1 to E2 which are placed as deposits within the E2 banking sector and in turn become external liabilities of the E2 private sector. The purpose or *raison d'être* of these flows is to take advantage of the risk subsidy (free insurance) from the EU enlargement process. The hidden subsidies or free insurances trigger substantial flows of resources and capitals - supranational, public, or private (banking, intra-firm, etc.) alike - from E1 to E2.

These funds are either E1 savings or pure bank credit (not backed by real savings) generated by the E1 banking system[11]. This leads to a rise in external debt, be it private or public, depending on where the capitals in E2 are channeled to (hereinafter referred to as D). Within the E2 countries, internal debt increases as well, mainly in terms of lending to the private sector.

Therefore, we can summarise the whole story along these lines: the debt level of the E2 countries increases significantly either through an external or internal

[11] The vast majority of banks in Eastern Europe (part of E2) for instance are subsidiaries of European banks.

impulse, but as a rule through both channels.[12] The ECB and the governments of the leading countries from E1 were perceived as guarantors for these riskier operations despite the numerous political and legal obstacles to such interferences. The entire system of debt accumulation in E2 was accompanied by the manifestation of crony behaviour, corruption and banditries, which are typical of such periods.

Moreover, the inflow of external savings and loans leads to looser lending conditions, higher salaries and consumption, and eventually to higher inflation (at rates higher than those in E1). With the advance of the catching-up processes in terms of prices, real interest rates in E2 would significantly decrease and even become negative because of higher inflation in E2. Domestic credit increases and is channelled either to sectors where gains from the rise in prices are expected or to investments made in inefficient projects. The growth of inflation at faster rates than those observed in E1 induces a real appreciation of the exchange rates and a loss of competitiveness. Consequently the current accounts in E2 countries deteriorate and the only way to offset this is the inflow of savings and capitals from the E1 zone with largely positive current accounts. The economic actors from E1 also begin to take risks, especially with regard to investments in E2, believing that their governments and the European institutions would be a sufficient guarantor.

In somewhat different analytical scheme the inflows of capital and cash from E1 to E2 could be considered as a kind of structural deformation of the production processes, a change in the inter-temporal restriction, destroying the set of economic preferences, sending wrong signals for consumption, investment and savings, etc.[13] Moreover, similar examples of interaction between E1 and E2 can easily be found in European history. For instance, the German expansion in Southeast Europe and the Balkan countries during the 1930s carried similar traits of an attempt at creating a common production process, i.e. complementing the E1 production process with that of E2. This entailed the periphery specialising in those production segments, which were not developed in the core-countries, namely agriculture and the production of consumer goods[14] which in turn would make it possible for the realisation of the expanded production processes in E1.[15] To prevent the

[12] This dynamics was also encouraged by the low international interest rates which were supported by the central banks of the leading countries, including the ECB.

[13] See for more Garrison (2001).

[14] Today, deindustrialization of E2 countries is increasingly a topic of discussion; see for example the analysis by Natixis (2011), ECB (2012).

[15] Some allusions to this type of processes are given in the well-known book by Gottfried Haberler (1946 [1937]), as for instance in pp. 68-71. Of course, the issues of capital export, imperialism and colonialism are at the core of Marxists' theory (Rosa Luxemburg, John Hobson, *etc*.) and even of studies by non-economists like Hannah Arendt (2002 [1948]).

breakdown of the common zone, apart from exerting political and military pressure, Germany also applied a range of administrative economic measures such as clearings, differentiated exchange rates and other technical practices.[16]

Turning to the current situation resulting from the interaction processes between E1 and E2, as was already discussed, is characterised by euphoric and artificial growth in E2. Consumption grows at high rates, just as investment in real estate aimed at profiting from the increase in price. Similar is the case of public investment in long-term projects, which are mostly inefficient and futile.[17] This accelerated economic activity creates the illusion of sustained growth of income and welfare. That in turn fuels anew the overall risky behaviour and accumulation of debts while falling short of generating in the same degree a growth of collateral and guarantees to match claims hereinafter denoted as Φ.

Within Φ, which is public by nature, visible and sound insurances (F) – most commonly in foreign reserves – decline considerably, as are fiscal surpluses in some countries, etc. at the expense of implicit, expected, virtual guarantees (V). However the free insurance and hidden subsidies would increasingly disappear. Finally, it becomes clear that the common guarantee fund ($\Phi = F+V$) is depleted and insufficient to cover for the liabilities (D) accumulated in E2. Then the European institutions and E1 countries prove to be a virtual anchor dangling in the air. Once free insurance has melted, the real explicit interest margin ($r_2 - r_1$) starts to decrease and to converge to the implicit margin ($r_2 - r_1 - \varphi$), where r_2 stands for real rates in E2, and r_1 in E1. The limits of this mechanism became clearly evident after the first signs of the global crisis. The private debts in several countries from E1 and E2 were nationalized and became public. The E2 public debts in turn started to be monetized by the ECB and became *de facto* E1 public debt. This logic of transforming debts has been explained on numerous occasions and will not be elaborated here.

[16] See Fisher (1939), Guillebaud (1940), Einzig (1941). It is interesting to note here that Hitler categorically refused to introduce the *Reichsmark* as an official currency in Southeast Europe as he believed that preserving the national currency makes the zone more resilient (see Einzig [1941:10]).

[17] This is a kind of evidence of maximal stretching of economic processes when the time horizon is extended to its maximum (long-term investments), or is maximally shortened (consumption) and destroying the middle sections of the economic process.

Description and formalisation of the model

The above cause-and-effect links can be represented with the following system of linear equations illustrating the relations between E1 and E2 (the model is purely illustrative, hence the linearity of relations).

$$(1) \quad D = \alpha_0 + \alpha_1(r_2 - r_1) + \alpha_2(-\Delta\varphi)$$

$$(2) \quad r_2 - r_1 \equiv i_2 - i_1 - \Delta\pi$$

$$(3) \quad (-\Delta\varphi) = \beta_0 + \beta_1\Phi$$

$$(4) \quad \Phi = V + F$$

$$(5) \quad V = \gamma_1\lambda_1$$

$$(6) \quad F = \gamma_2\lambda_2$$

$$(7) \quad \lambda_2 = \eta_0 - \eta_1\lambda_1$$

Equation (1) shows the movement of resources (savings and credit) from E1 to E2 i.e. the accumulation of liabilities D in E2 as a positive function of the difference in real risk-free interest rates ($r_2 - r_1$), and a positive function of the "EU-accession premium" (the risk-free insurance) denoted *(- φ)*. Identity 2 shows that the real interest rate differential ($r_2 - r_1$) presents the nominal interest rates differential ($i_2 - i_1$), adjusted for inflation through the differential ($\Delta\pi$). Equation 3 shows the link between the insurance fund Φ and the European premium (- φ). In identity 4 we can see that the guarantee fund is composed of visible guarantees, mainly foreign reserves, *F*, and implicit or virtual guarantees *V*. The relation (5) shows the virtual guarantees *V* as a function of the credibility of the European anchor (λ_1) and relation (6) – the real *F* as a function of the EU-rules compliance discipline effect (λ_2).

And finally (7) shows the relationship between the discipline effect (λ_2) and the effect of EU credibility, i.e. the insurance, (λ_1). Presumably, in time, credibility and discipline will move to opposite directions, i.e. the insurance, along with the belief that one would be saved if any problems arise, undermine the system and lead to the accumulation of debts and bad investments.[18] In other words (and somehow paradoxically), the more credible the EU is in applying and enforcing its

[18] This negative relationship, which can be subject to empirical validation, has been emphasized in Ialnazov and Nenovsky (2011), Nenovsky and Villieu (2011).

policy, the less capable it is of insuring individual states' discipline in the periphery. Consequently, during the "bad" part of the dynamics the robust guarantee weakens discipline, thereby deteriorating the overall condition of *Φ*, which can no longer cover for *D*, and that in turn increases risk and eliminates the free insurance, thus reducing the interest differential. Capitals start flowing out from E2 and back to E1 or elsewhere, which paralyses credit and hinders economic activities in E2.

The parameters $\alpha_0, \alpha_1, \alpha_2, \beta_1, \beta_2, \gamma_1, \gamma_2, \eta_0$ and η_1 in the above system of linear equations are positive. By simply transforming the system of equations (7, 6, 5, 4, 3 to 1), we can obtain the partial derivatives, i.e. the condition (8), under which the liabilities, debts (*D*) in E2 grow persistently as a result of the credibility effect in the European system (λ_1), is as follows:

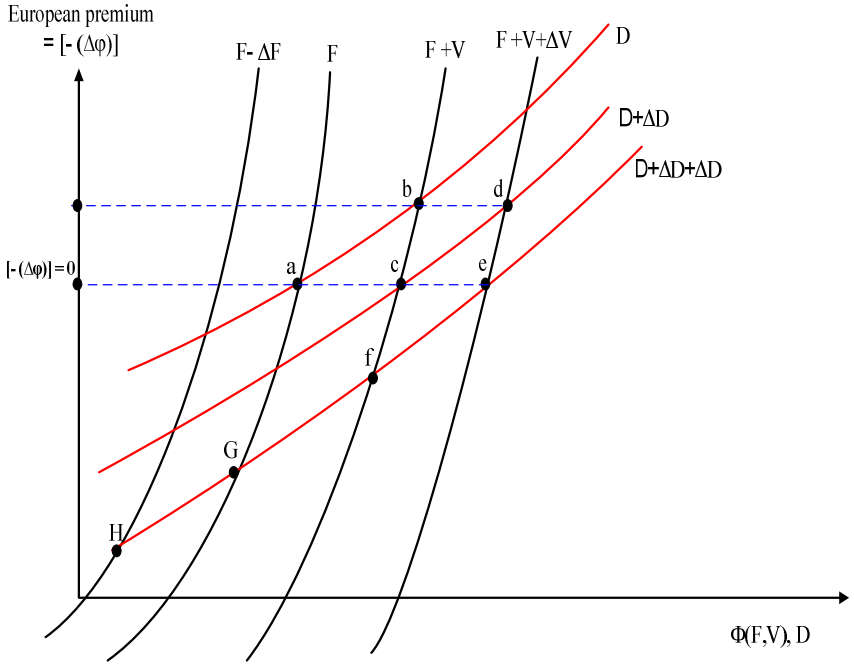
(8) $\frac{dD}{d\lambda_1} > 0$, or $\gamma_2\eta_1 < \gamma_1$

The two multipliers are different combinations of the ratios between the three elasticities: γ_1, γ_2 and η_1. One should keep in mind that γ_1 is the change in implicit guarantee as a reaction of the credibility in EU and γ_2 shows how the visible, explicit insurance, mainly foreign exchange reserves and budget surpluses, react to the EU disciplining influence. Also, η_1 shows the degree by which credibility destroys discipline.

Thus, according to (8) for instance, debts and liabilities in E2, marked by *D*, will increase as a result of the EU credibility as long as the product of the elasticity with which discipline generates foreign reserves, and the elasticity of loosening discipline as a result of EU, is lower that the elasticity of credibility in the virtual anchor – the belief that one will be saved.

The insurance and self-disintegrating power of the European project can also be presented graphically.

Graph 1. Insurance game dynamics



The free European premium (or risk subsidy) in the interest rate differential is shown on the vertical axis and is equal to (-φ). The horizontal axis shows forex reserves *F*, virtual guarantees derived from EU-membership *V*, and liabilities that have to be insured *D*. All these variables are characteristic features of the peripheral E2 countries. Assuming that the European insurance game starts at point *a*, where *V* is suddenly added to forex reserves as a result of the virtual guarantees of EU (which are in most cases accompanied by real cash flows from the European integration funds) thus arriving at (*F*+*V*).

The equilibrium is forthwith shifted to point *b*, where the European insurance appears. As mentioned above, it is not taken into account in the interest margin, but is instead a kind of a hidden subsidy. Core E1 countries' investors strive to use this insurance and so E2 liabilities towards E1 increase (*D*+Δ*D*). In point *c*, this premium is once again eliminated. Then one can assume that the European rhetoric and way of thinking augment the virtual guarantees up to (*F*+*V*+Δ*V*). This again leads to the emergence of a premium in point d and again there is an inflow of

foreign savings ($D+\Delta D+\Delta D$). The premium is once again eliminated in point e. At that point, a range of processes become clearly evident in the real economy of E2 which have developed slowly and imperceptibly, yet irreversibly. What is implied here is consumption and lending growth, higher incomes, loss of competitiveness and in general deterioration of current accounts. The increased consumption in E2 is offset by an inflow of savings from E1, whose current accounts are largely positive, increasing D once again. Forex reserves in E2 start diminishing quickly as part of Φ and are increasingly replenished by virtual guarantees, i.e., within Φ the portion of F is progressively declining and is being replaced by V.

An inflexed point is reached where the premium becomes negative, i.e. the liabilities need to cover not only F but also ($F+V$). At a moment like these virtual guarantees cannot replace the real ones, which have in turn declined and a point h is reached. That is a point of crisis, when E2 economy totally shrinks and effectively diverges from E1. The premium is negative and a run-up on deposits and outflow of capitals to E1 is observed. In order to handle this negative premium, either liabilities D have to shrink further, which translates into banking, lending and real economy failure, or create a new project, new virtual guarantees that would increase the guarantee fund. The latter is very difficult to realize. Thus, the total sequence of moves presented in Graph 1 is from point a to point b, then to c, then to d, then to e, then to f, then to g, and finally to h. The scheme presented thus far aims to illustrate the internal instability of the European project, which contains genetic processes leading to its breakdown.

Collateral architecture and risk spillover

It is obvious that the size, strength and structure of collateral in relation to E2 are essential in putting forward the idea of the internal vulnerability of the European Union and its breaking down into at least two segments: a core E1 and a periphery E2. As was already presented in an as simple way as possible, the collateral Φ is composed of an explicit F and a virtual V part with the boundary between them being often blurred.

F in general includes the net external assets of E2, in particular forex reserves, public by their legal nature and shown on the asset side of the central bank's balance sheet. Such type of collateral could also include the government's fiscal surpluses and fiscal reserves held either with the central bank or with commercial banks. To various degrees, F are pooled in the form of institutions such as Deposit Insurance, Lender of Last Resort, Too Big to Fail, Too Interconnected to Fail, etc., intended to ensure guarantees to interfere in times of crisis, and which are not always backed by real funds (savings).

The implicit and virtual guarantees *V* extend to some oral and gentlemen commitments and non-formal promises to help E2, made by the economic agents of E1 and at a supranational level, governments and ECB in particular, as well as a number of private institutions. They are all, in a sense, guarantees for risk taking in E2. It is important to note that as the insurance game evolves over time, the *F* guarantees in the guarantee pool Φ get smaller and smaller and eventually transform into virtual. Hypothetically, a point of time can be reached where $\Phi = V$.

Developments take an even more interesting turn if we look into the nature of explicit guarantees *F* of E2. F is composed for its greater part of E1 securities, internal debt of the E1 countries. If we take for example the case of Bulgaria, nearly all of the currency board assets (except gold) are invested in European securities (as the crisis evolved they were more and more restructured into German and northern Europe securities) and euro cash. These securities carry the risks of E1 debts as well as possible euro collapse. A configuration is reached whereby the E2 currency, which is debts of their public monetary institutions, is de facto covered by other debts, those of the E1 governments. A closer and unbiased look will reveal that what is considered an external and risk-free anchor, a visible and obvious resource for the countries in E2, is actually a guarantee, which is risky and virtual by nature. The monetary system in E1 does not have any external anchor as becomes all the more clear when the two zones are looked upon as one whole. Even the euro banknotes, which are part of E2 forex reserves, are also ECB debt. Besides, this debt of the ECB is again covered by E1 governments' debt – a process, which becomes obvious with the evolution of the crisis. An accumulation of debts takes place and a pyramid of debts is formed which does not have any external anchor.[19] Or, in summary, we could say that for its greater part, the European guarantee fund of E2 is virtual, which becomes even clearer with the acceleration of the insurance game and even more so with the evolution of the crisis.

Let us look at some of the channels via which the European integration triggers the increase of risk and its wrong redistribution, leading "unexpectedly" to its collapse.

In the first place, let us look at the incentive coming from the flow of resources (savings and cash) from E1 to E2, which can take various forms. Two groups could be mainly distinguished: those of private savings from E1 and those of the European funds (pre-accession, structural or cohesion, and all others of this kind).

[19] Of course, the experts are aware of this, but they nevertheless keep saying that money is confidence and the banking and financial systems are confidence. This, however, does not change things; under the gold standard money is confidence too, backed however by real worth outside the system that is nobody's debt.

If we look at the cohesion funds in particular (which although under-absorbed), have detrimental implications for E2's macro-economy. In the first place, these funds enter as liabilities of E2 banks, which automatically reduce the guarantee funds. Besides, they create very harmful practices of cronyism, corruption and banditism, although we are constantly assured that actions are undertaken to counteract these. Basically, these funds boost credits and through the various fraudulent schemes are most commonly channelled to sectors which rely on speculative increase in prices, such as the construction, real estate sectors, and others. Hence, the upward pressure on salaries, incomes and catching-up movement of prices in general. It is exactly this last one that leads to "eating up" free European risk subsidy ($-\Delta\varphi$). As a whole, the flow of resources undermines the system of economic agents' preferences and encourages the emergence of all sorts of bandit, venal and non-market strategies.

Secondly come the channels, via which, as a rule, institutions and rules are mechanically transferred from E1 to E2. These institutions, being adjudicated over E2 circumstances, lead to a range of "perverse and unexpected outcomes" by often changing behaviours in a direction opposite to what was expected.[20] One such example is the pre-accession closing of chapters of the EU legislation, whereby a number of directives were imperceptibly adopted, which in an E2 context induced more risk taking. Such was, for instance, the deposit insurance directive, which required the insurance of deposits of up to 20,000 euro per individual, and later that was raised to 100,000 euro. In the case of E2, this was effectively translated into covering practically all deposits as the average deposit size is too small. This resulted in a curious guarantee of the whole banking system (much like the practice during the socialist period) with all familiar mechanisms of moral hazard and risk underestimation. This is one example of institution that leads to the emergence of the above discussed European premium (or premium for enlargement) and which becomes a major transmission channel. Furthermore, from a broader perspective, the process of adoption of E1 legislation in E2 has led to the emergence of a specific "legal illusion" according to which European integration is a process of "legal" and nominal convergence with economic, real convergence following only too naturally and under the control of bureaucrats and politicians. Paradoxically, countries where Marxism prevailed have forgotten that, although important, legal and political processes cannot replace the need for structural economic changes.[21]

[20] The transfer of institutions and their wrong utilization has been object of numerous studies, more often in the light of transitional economies (see Polischchuk, 2008) and less often in the context of EU enlargement.

[21] It should also be noted that the "state-bureaucratic" and legal way of understanding convergence has brought the E2 economic actors closer to the state and to the European civil servants and has made them dependant on these. This proximity has further intensified the

Thirdly, an interesting channel, although in a different context, has been examined very well by Dowd, Hutchison and Kerr (2011). Before the appearance of the E2 premium, during the initial drop in real interest rates in E1 in early 2000 the capital as a cheaper production factor began to replace labour and to expand and lengthen the production structure. An inflow of labour force from E2 to E1 was observed and a great number of delocalisations or, generally speaking, the labour in E1 was replaced by capital from E1, or by labour from E2. At the time of enlargement and the appearance of the premium in E2, the capitals from E1 began to get channeled to E2, where a process of substitution of the labour force with capitals began to be observed as well. Here, however, the substitution processes came to a standstill because the work force in E2 was depleted and there was nothing to replace it. After a period of time, a labour force shortage started to show - a fact well familiar in the E2 countries, especially in the construction and services sectors. Ultimately, a point was reached where the salaries and incomes in E2 increased, unit labour cost and inflation went up, and productivity and competitive power declined.

Conclusions and perspectives

In this paper we have presented an analytical model which we have referred to as "insurance model" allowing a relatively good explanation of the EU internal instability and of the processes that led to the current crisis. The endogenous dynamics of disintegration, to put in the simplest way, is caused by the aspiration to use a "free insurance" in peripheral Europe, the insurance itself being the outcome of the emergence of a large guarantee fund either explicit or virtual (promises among others). Certainly, the model holds much in common with the moral hazard models, with some of Dooley's theoretical formulations (Dooley, 2000), and with a number of other models which have been increasingly making their way not only into the theory but also into the economic policy of European Union.

First, from a theoretical and empirical perspective, one of the direction for future research is to study each of the relations in the model: between the guarantee fund (collateral) and the free insurance (risk underestimation); the mechanisms of formation of the insurance fund and its structure; the link between the confidence,

---

sense of security and guarantees naturally boosting "bad behaviour", *i.e.* raising the overall risk level; hence, the conclusion that in general the presented insurance model is of stronger impact in countries with venal and bandit economic structure. Yakovlev and al. (2009) offer an interesting analysis of the behaviour of Russian companies, which, due to their close relationship with the state, assumed higher risk and actively borrowed from abroad. Later, during the crisis, they were discretionarily bailed out. At the same time, Russian savings were exported.

credibility effect and the discipline effect, which can be presumed as non-linear, etc.

Second lesson and more importantly, with regard to the economic policy on a national and European level, we need to look for the institutional mechanisms which, in short, could prevent the emergence of the insurance game, hence the processes of internal disintegration of the European economy. Although much needs to be done both theoretically and empirically, as pointed above, the philosophy of economic measures is generally clear. It has to do with a reduced guarantee fund, less promises of assistance (bail-out), less flows towards the periphery, stricter control mechanisms over these flows, etc. A note should be made that some of these ideas, although slowly and with difficulty, have been making their way into the policy of European institutions. In this light we could see some of the measures in the fiscal policy and fiscal control. On the other hand, the efficiency of the various types of newly established guarantee institutions as regards the financial and banking system, the mechanisms of bailing out distressed and insolvent countries, the issue of a common, supranational debt, etc., is questionable (of course from the standpoint of the presented model).

References

Amable, B. (2005). *Les cinq capitalismes. Diversité des systèmes économiques et sociaux dans la mondialisation*, Seul, Paris

Arendt, H. (2002 [1948]). *L'impérialisme. Les origines du totalitarisme*, Fayard, Paris.

Batou, J. (2000). Les inégalités. Une ou deux Europes?, *Revue économique*, 51 (2): 323-334.

Bonnet, G. (1933). The economic reconstruction of Central and South-Eastern Europe, *International Affairs*, 12 (1): 19-36.

Csaba, L. (2007). *The new political economy of emerging Europe*, Akadémiai Kiadó/Kluwer, Budapest

De Grauwe, P. (2011). The Governance of a fragile Eurozone, CEPS Working Document N 347

Delaisi, F. (1929). *Les deux Europes*, Payot, Paris.

Dietrich, D., T. Knedlik, and A. Lindner (2011). Central and Eastern European countries in the global financial crisis: typical twin crisis?, *Post-Communist Economies*, 23 (4): 415-432.

Dooley, M. (2000). A model of crises in emerging markets, *The Economic Journal*, 110: 256-272

Dowd, K., M. Hutchinson, and G. Kerr (2011). The coming fiat money cataclysm - and after, 29th Cato Institute Annual Monetary Conference, November 16, 2011.

ECB (2012). Competitiveness and external imbalances within the Euro area, ECB Occasional Paper N° 139.
Einzig, P. (1941). Hitler's "New Order" in theory and practice, *The Economic Journal*, 51 (201): 1-18.
Farkas, B. (2011). The Central and eastern European model of capitalism, *Post-Communist Economies*, 23 (1): 15-34.
Fisher, A. (1939). The German trade drive in Southeastern Europe, *International Affairs*, 18 (2): 143-170.
Garrison, R. (2001). Time and money. *The macroeconomics of capital structure*, Routledge, London and New York
Gros, D., C. Alcidi (2011). Adjustment difficulties and debt overhangs in the Eurozone periphery, CEPS Working Document, n° 347.
Guillebaud, C. (1940). Hitler's New Economic Order for Europe, *The Economic Journal*, 50 (200): 449-460.
Haberler, G. (1946 [1937]). Prosperity and depression. A theoretical analysis of cyclical movements, United Nations, Lake Succes, New York.
Luengnaruemitchai, P., S. Schadler (2007). Do economists and financial markets perspectives on the new members of the EU differ?, IMF Working Paper WP/07/65.
Mongelli, F. (2013). The mutating euro area crisis. Is the balance between "sceptics" and "advocates" shifting? ECB Occasional Paper N° 144.
Natixis (2011). La crise de la zone euro est finalement facile à comprendre, NATIXIS Flache Economie N° 835.
Nenovsky, N. (2012). Theoretical debates in Bulgaria during the great depression. Confronting Sombart, Marx and Keynes, Oeconomia - (History-Methodology-Philosophy), 2(1): 67-101.
Nenovsky, N., K. Tochkov, and C. Turcu (2012). Monetary regime and EU accession: Comparing Bulgaria and Romania, *Communist and Post-Communist Studies*, forthcoming, 45 (3/4): 13-23.
Nenovsky, N., P. Villieu (2011). EU enlargement and monetary regimes from the insurance model perspective, *Post-Communist Economies*, 23 (4): 433-447.
Nenovsky, N. (2010). EU enlargement and monetary regimes from the insurance model perspective, The William Davidson Institute Working Paper N° 997.
Polishchuk, L. (2008). Misuse of institutions: Patterns and causes, *The Journal of Comparative Economic Studies*, (4): 57-80.
Röpke, W. (1942). International economic disintegration, in William Hodge (ed.), London.
Rugraff, E. (2010). Strengths and weaknesses of the outward FDI paths of the central European countries, *Post-Communist Economies*, 22 (1): 1-17.

Slim, A. (1997). Intégrations, désintégrations et réintégrations en Europe de l'Est: les théories traditionnelles remises en question. *Revue d'Etudes Comparatives Est-Ouest*, 4 (décembre): 5-83.

Vincent, A. (2011). Capital flows and development in CEECs, BNB Paribas Conjuncture, October: 17-26.

Yakovlev, A., Y. Simachev, and Y. Danilov (2010). The Russian corporation: patterns of behaviour during the crisis, *Post-Communist Economies*, 22 (2): 129-140.