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Trap of the Monetary Union – Consequences for the EU Cohesion Policy and Other Social and Political Effects

INTRODUCTION

Each crisis situation has at least two aspects. It can be a chance for a complete change of system which will enable a dynamic development in the future. It can also be destructive though, for the institutional system in question and for the political community. Especially when the problems are not being solved or just covered up, and the public policies only feature minimizing the costs incurred during the transition from one crisis to another.

The way in which the crisis is being dealt with shows the quality of the political elite and also the effectiveness of the given political power system. It indicates its dominant action rationality. Are the actions undertaken temporary or rather strategic? Are they undertaken with reference to the interest of the whole community and durability of the system or only with reference to the dominant (but individual) interests?

We can look at the crisis of the common currency from this analytical perspective. It has showed the weakness of the political system in the EU (especially in the eurozone). It revealed the inability of the political elites to solve problems in a lasting and efficient way. The tendency is to treat the *symptoms* rather than the underlying *causes of the problem*. While it is true that the temporary actions undertaken may stabilize the situation, they can also generate successive difficulties in the near future. This way, the objective is a short-term appeasement of the situation rather than a lasting and comprehensive solution of the problem. It is not a coincidence that the declared objective of many decision-makers is the stabilization of the markets and not the economic growth. It is more and more visible that the political elites lose control over the course of events or even contact with reality [Boll et al., 2012]. They focus on political marketing in order to calm the investors and their own voters, instead of solving the problems in an effective way. It is, as it seems, a characteristic feature of many modern democracies. Politics became more of an art of marketing and electoral manipulation than an ability to conduct system operations in a strategic time perspective.

MAJOR CHALLENGES OF THE COMMON CURRENCY SYSTEM AND THE POTENTIAL FOR FIGHTING THEM

Three major weaknesses of the common currency system should be named:

- (1) Disparity of macroeconomic parameters and the tendency to increase structural diversity between the individual EMU members. This concerns primarily the growing disparity in economic competitiveness and the rate of inflation between the leading and peripheral Euroland countries (especially PIGS¹).
- (2) Limiting economic growth. During the crisis this is particularly evident in the peripheral countries.
- (3) Lack of a proper economic governance as well as other institutional shortages of the system in question that stem from it. It is connected with the centralization of monetary policy at the EU level and at the same time the decentralization of fiscal policies in member states.

The fundamental institutional problem of the euro system is that the Union exists without any strong political power (that could be compared to the sovereign power of national states). In international monetary systems of this kind power may be established, for example, by a dominating geopolitical player that would impose its institutions and political will but will also financially guarantee the functioning of a currency union during a crisis. Other solution, especially in a situation when there is no one dominating state or when we are dealing with democratic countries, would be to build a political federation. This makes it necessary to form electoral institutions that would enable transferring the fiscal policy up to the federation level. In case of the European currency system neither of the above mentioned solutions is employed. Most importantly, the monetary union is not coupled with any political union institutions that would legalize the transfer of fiscal competence from the national up to the EU level. Instead we have strong sovereign powers at a national level and developed electoral institutions up there as well that control the authority over fiscal policies. According to experts (De Grauwe 2007, 113), the currency union without a strong political union between the member states is not able to last in the long run. It will not be able to shoulder especially the burden of more difficult problems of the deteriorating economic situation.

Up to now, the reforms undertaken in the euro area are overdue and mostly partial. They postpone problems in time, rather than solve them. They are mostly aimed at increasing the budget discipline of the member states and at enhancing the Stability and Growth Pact. The so-called *Fiscal Compact* which has been agreed during the EU summit in January 2012 [*Treaty on Stability...*, 2012] can serve as an example. It is a document that mobilized a several-month internal debate in Europe but it has brought very few practical results. It mostly

¹ PIGS: Portugal, Ireland, Greece, Spain.

repeats the existing provisions in European law (inter alia, the so-called *Six-Pack* adopted in 2011). During the debate, some of the new suggestions have been crossed out or considerably appeased. It was like that, among other things, in the case of the operation of transferring some elements of the *Euro-Plus Pact* to this document and the requirement to register the new rule concerning the reduction of the structural deficit in the national constitutions. Because of the fact that the document has taken the form of a treaty outside community structures and European law, it will be problematic to use the EU institutions on its basis. It means that there will be difficulties while monitoring the progress in introducing its provisions and impossible to impose fines on countries which will not implement them.

The main direction of the debate was focused on political and structural matters. It was primarily about the French aspiration to use the present crisis in order to deepen the division of the so-called *Two-speed Europe*. A sign of this tendency was, among other things, an attempt to strengthen the EU's political power in hands of the eurozone member states. Other countries, like Poland, declared willingness to stop these processes. Furthermore, the propaganda objectives, related to reassuring the investors or national voters, were also important. As a result, much effort and energy was wasted on political and marketing matters, instead of finding solution to the main problems of the euro system².

The European anti-crisis actions introduce instruments that improve financial liquidity and save from bankruptcy the member states or financial institutions (for instance, the most endangered are German and French banks). However, those instruments are not completely effective. Above all because of the fact that they do not have proper capital reserves. As an example can serve the European Stability Mechanism, ultimately approved during the EU summit in January 2012. It will have a budget of 500 billion euros, which amount, in the opinion of the experts, is definitely too small in the face of eurozone problems (the funds pool should be twice or three times bigger). Admittedly, the German government agreed to the advance initiation of this fund (from 1 July 2012 it is to replace the present EU Stability Instrument), but it blocks the possibility of providing it with more capital. Germany also rejects the pressure of other members of the currency union to introduce eurobonds or a greater scale of the International Monetary Fund financing. Additionally, it is also against some more active anti-crisis actions of the ECB, especially the direct purchase of a large number of the bonds of the Euroland countries threatened with bankruptcy.

The motives of the German government are clear. It does not want to incur excessive costs of saving the euro area. Instead, it recommends fiscal savings in the Euroland or attempts to burden others with the costs of the crisis: private investors, countries outside the eurozone or the EU (cf. Chancellor Angela

² Cf. A statement of the Minister for Foreign Affairs of Luxembourg [*Merkel's Fiscal Pact...*, 2012].

Merkel's visit to China in February 2012). For now, the German strategy has been ineffective. Not only does it not contribute to solving the main problems, but also it does not even guarantee the stabilization of the situation in the medium term.

Another example of ineffective actions, which are rather made for the short term and do not solve fundamental problems, is the strategy of the ECB. Because of the fact that the European treaties forbid it the direct purchase of a large number of the bonds of the member states, it seeks other ways to stabilize the financial system. On the one hand, it is a policy of low interest rates; on the other, a financial support of a gigantic amount of low-interest loans to the banking sector. In December 2011, the ECB gave 489 billion euros in three-year loans at a 1% interest rate and then again 528 billion euros in February 2012. The European banks, however, started to buy the bonds of the member states, which contributed to reducing their profitability. Everything indicates that it has a temporary effect, with the expiration date on the day the ECB will stop pumping the money into the banking system.

At the same time it creates subsequent problems for the future. Above all, it introduces to the banking system more and more bonds of the countries threatened with bankruptcy. In the situation of insolvency of those countries, the banks will be much more burdened with the losses because of this fact. The actions of the ECB also contribute more and more to the financial disequilibrium of the European System of Central Banks (so-called *TARGET 2*), reaching 800 billion euros at the end of 2011. Apart from that, the ECB is in possession of the bonds of the countries threatened with bankruptcy, worth in total 220 billion euros. In the situation of an uncontrolled bankruptcy of one of the euro-zone countries, it poses a threat of serious losses for the ECB and it will be necessary for the member states to provide the Bank with more capital.

It is not difficult to guess that the preponderance of the costs of this kind of intervention would have to fall on the richest member states, especially on Germany. That is why this country defends itself so much from the further ECB interventions. There is also a possibility of increasing the inflation pressure under the influence of the ECB's monetary expansion. However, the improvement of the inter-bank liquidity has not been achieved, of which a proof can be the high scale of short-term deposits in the ECB private banks (so-called *overnight*, sometimes even exceeding 500 billion euros). Bank's equity does not stimulate the real economy either because the funds received are not being loaned to companies; instead, they are deposited in government bonds or in the ECB's accounts. All in all, the ECB's actions should be acknowledged as relatively not very effective. These only temporarily stabilize the situation and they create a greater risk and new problems in the upcoming future.

What is worse, the political elites in Europe do not accept those three euro-zone system challenges of which I have mentioned above. The problem of the

structural disequilibrium in the euro area has not been solved yet, especially the worsening competitiveness of the weakest peripheral countries. In this situation, the remedy should lay in strong redistribution programs that would improve the competitiveness of the weakest eurozone members. Another solution should be to impose restrictions on capital flow (especially the speculative one), in order to limit the excessive increase in assets (e.g. immobility prices) and inflation growth. In addition, the capital control (particularly the short-term one) reduces the risk of appearance of financial crisis and deflation (in the situation of a sudden withdrawal of speculative investments) [Abdelal, 2009, 48]. Structural reforms within the individual countries are also absolutely necessary, especially those reducing budget expenses and at the same time increasing the national incomes and holding back the pay rise.

The European national leaders undertake the above-mentioned actions only to a small extent. The problem of an insufficient competitiveness has been entirely left to the national authorities, without having any actual support from the EU. As far as the national budget expenditure side is concerned, a cost reduction programme is recommended in the first place, without paying much attention to increasing the incomes (e.g. by stimulating the economic growth and tax revenues). The so-called internal devaluation is being suggested, among other things by attempting to impose administrative restrictions on pay rises. It is extremely socially expensive, and therefore difficult to adopt because of electoral reasons. On a common currency basis (and having no possibility of devaluing the national ones), restoring the economical competitiveness without significant help from outside is practically impossible.

The remedy for the weak economic growth in Europe has not been found. On the contrary, the fiscal consolidation-related recipes used during the crisis drove several eurozone countries into a long-term recession. The EU summit in January has brought many political declarations that have already been made to promote the economic growth [*Statement of the members...*, 2012]. However, those are more media actions than an authentic political will. Because of the fact that the interests of the member states vary, the development of the market of services in the EU is still blocked.

There is no Community patent. Actions that are suggested, are once again focused on treating the *symptoms* rather than the *causes of the disease*. For example, the emphasis has been put on the fight against unemployment instead of on the restoration of the low competitiveness of some EU economies. The growing pressure on using the EU structural funds in the countries most affected by the crisis is now becoming visible. At the present stage of discussion, the talk is about the possibility of unused funds of the cohesion policy being reallocated to the Euroland countries. It is connected with the introduction of further bureaucratic difficulties in the use of those funds within the cohesion policy frame-

work [Grosse, 2012]. Another action is the continuation of the works on the EU fiscal policies coordination, especially on tax harmonization.

It is to be acknowledged that the suggested solutions will have little effect on economic growth. Partly they have a marketing character and partly they are related to the realization of economic interests of the leading EU countries. It is especially about the tax harmonization, which is profitable above all to France and Germany (where the taxes are relatively high). However, this harmonization will restrict competitiveness of the peripheral countries, which are creating their own advantages on, among other things, low production costs (including low taxes).

Finally, there is no proper economic government in the Euroland. While it is true that the coordination of economic policies has been enhanced, those actions are insufficient. The strengthening of the Eurogroup competences is also unsatisfactory. The suggested change in the treaty within the confines of the so-called *Fiscal Compact* is heading towards political and constitutional restructuring of the EU. It is about an improvement of the way of intergovernmental decision-making, centralization of power in the hands of the leading eurozone countries (Germany and France) and increasing the already existing EU power hierarchy between the central and peripheral countries. Originally, it is to greater the chances of disciplining the politically weaker countries, e.g. by various sanctions and conditioning the bailouts. Also, it should accelerate making anti-crisis decisions and their further implementation.

In practice, it results that the improvement of the Europe's political system has little effects. The measures undertaken instead of enhancing the management, rather create additional problems. It is like that in the case of an intergovernmental treaty accepted outside of the Community structures (the *Fiscal Compact*). It makes it more difficult to use the EU institutions in order to impose sanctions on the countries that do not comply with stricter rules of the fiscal discipline. Another example is a low effectiveness of the EU instruments that are to enhance the fiscal consolidation in Greece. The representatives of the EU institutions are helpless because the Greek government does not implement the announced reforms, and the fiscal and economic situation of this country is getting worse and worse.

Above all, it is related to an improper direction of the adopted anti-crisis strategy (radical savings without any actions to repair economic structures). Therefore, it is not surprising that the successive EU aid tranches for Greece do not save the situation. It is about an amount of 110 billion euros of the first loan (agreed in 2010), 130 billion euros of the second one (2011) and a reduction of the Greek total debt of at least 100 billion euros (2012). They also result insufficient. Planned is another aid package of more than 50 billion euros. As it can be seen, the eurozone political system is ineffective and it has very little reform potential.

CONSEQUENCES FOR THE FUTURE COHESION POLICY

As a result of the fiscal crisis in the EMU member states, some net taxpayers which contribute to the EU budget demanded a reduction in the funds earmarked for the cohesion policy. They wanted to reduce their EU membership contributions during the period of fiscal consolidation and ensure that national governments trim off the fat. There is a strong trend in the discussion on the multiannual Community budget for the years 2014–2020 to reduce EU financing of expenditure, including the cohesion policy. Though final result of this debate are not yet known, this tendency is bothering. It concerns such a construction of regulations within the new cohesion policy so as to effectively limit the absorption of funds from the EU budget. This would mean in practice that the unused funds could be allocated to finance other European objectives or return to national budgets of particular countries.

There are many examples like the introduction of a more rigorous *capping* to lower the level of accessible funds from the present 4 to 2,5% GDP of a given member country [*Regulation of the European Parliament...* Article 9, 2011, p. 12]. It is worth recalling that in the current EU budgetary period the allocation for our country is more than 3% of GDP. This is a dangerous proposal, taking in particular the possibility of a slower economic growth in Europe.

Another example is the introduction of a more rigorous conditionality regulating the use of fund resources. Literature [Bachtler, 2011] indicates that the trend observed in the cohesion policy to successively introduce provisions aimed at improving the quality of spent measures does not contribute to that purpose. Bureaucratic difficulties are being multiplied and the absorption of financial resources is being impeded. The latest EC's regulatory proposals imply much more extensive supervisory procedures, including the reporting. The idea of conditionality – although substantially justified- allows for the suspension of further payment of European funds in the case there was no progress in the implementation of purposes and indexes implied by the project. Undoubtedly, it will be hinder the absorption of EU funds.

Another manifestation of the potential limitation of funds may be the so-called macroeconomic conditionality [*Regulation of the European Parliament...* Article 21, 2011]. It allows for the suspension (wholly or partly) of payments for the sake of the cohesion policy provided a member country does not meet the fiscal criteria regulations. For example there could be a lack of necessary development in the process of regulating extensive deficit or a lack of compensatory actions when it comes to reforms in public finances. Sanctions concerning fiscal criteria should not be a condition to receive support within the framework of the cohesion policy. The above mention policy is potentially the only EU's supportive instrument to improve economic competitiveness and growth in less developing member countries and regions. Without a substantial improvement in the eco-

conomic structure and without a GDP growth neither effective actions nor reforms in the public finances sector are possible. Actions for fiscal consolidation restrict the growth rate, as well as they may cause difficulties in finding public funds necessary for co-financing the investments in the cohesion policy. Already it is more difficult to manage large investments within the framework of this policy in Poland because of the risk of surpassing the level of 55 percent of the public debt in relation to GDP³ In addition, the Minister for Finance imposes on local authorities some restrictions when it comes to the deficit, which hamper cohesion investments⁴. Taking into account these considerations, as well as the difficulties in meeting by Poland the requirement to reduce the budget deficit in the last period, macroeconomic conditions pose a serious risk for the absorption of funds within the framework of the cohesion policy.

Macroeconomic conditionality should be assessed critically, but the introduction of a system solving the problem of Member States facing budgetary difficulties with co-financing which decreases by 10% of the required level is a good idea [*Regulation of the European Parliament...*, Article 22, 2011]. This applies in particular to countries receiving financial support from the EU from the European Stability Mechanism (intended only for the eurozone members). This may facilitate the implementation of the cohesion policy during the period of crisis in public finances. At the same time this example illustrates the conflict between the EC's proposals. On the one hand some financial facilities are being implemented, while on the other threats concerning a total suspension of the cohesion policy can be sensed. Because of this criteria for macroeconomic assessment should not be a condition for receiving funds from the cohesion policy.

Another way to limit the amount of funds for the less developing regions (Poland included) is the proposal to divide resources from the European Social Fund (ESF). Only in 25% they can be allocated to these regions [*Q&A...* 2011]. Also the proposal to increase credit instruments within the framework of the cohesion policy may lead to an actual reduction of funds. This is related to the fact that credit procedures are often more difficult and demanding than grants (there are officials' controls as well as banking or other institutional verifications). The formula for the application of the financial instruments will be primarily regarding all the projects offered for enterprises or those which may bring financial advantages [*Regulation of the European Parliament...*, 2011, p. 10]. This means that it would be hampering the absorption of funds particularly in the segment which is most important for Poland's development and for the stimulation of economic growth, thus in the area of entrepreneurship support. In

³ An example is the delay in the construction of the A1 motorway, since its costs could increase the public debt [see: Stefańska, 2011].

⁴ Insofar as for the reduction of the industry sector deficit targeted at 8 billion zlotys per year [Skwirowski, 2011].

addition, it might deter certain beneficiaries from participating in such projects (and even more if there were competitions for non-returnable grants simultaneously) It should be added that in Poland relatively little small and medium sized operators carry out investments through bank credits. Most frequently they are carried out on the basis of their own resources or non-refundable grants.

The Commission announces that the idea of “innovative financial instruments” will in the future be used in wider scale for all types of investments and by all types of beneficiaries. Such an extension of the instruments should probably bring further limitations in the possibility of using EU funds. For example public entities rather than finding only the required co-financing will have to use all the resources for project investments (although instalments for the repayment will spread out over a longer period of time). Such a limitation will be severe especially in the situation of fiscal consolidation, which reduces the amount of investment resources available from the public authorities’ budgets. Now it is expected that during the period between 2014 and 2020 VAT would not be an eligible cost. This will reduce the possibility to finance investments within the cohesion policy by public (and private) beneficiaries.

What should also be highlighted is the risky, from the Polish perspective, proposal of introducing competition mechanisms into the transeuropean transportation instrument (the Linking Europe initiative). A part of the allocations from the Cohesion Fund (10 billion euros) will be saved for the financing of transportation within the framework of this instrument. It constitutes 20% of the total value. Resources from the Cohesion Fund will also be subject of the competition procedures, although it will probably regard only authorised countries. According to experts [Furgalski, 2011; Stefańska, 2011] Polish entities may encounter serious difficulties in winning these competitions, given the problems in the preparation of transportation projects in our country. Similar experiences are observable when it comes to other types of competition procedures in the UE. For example from 7 Framework Programme polish participants received only 200 million euros from 53,2 billion euros offered by Brussels in the years 2007–2013 [Osiecki, 2011]. Nonetheless, in this way we could gradually move away from national envelopes to competitions within the cohesion policy framework. In a similar manner we move away from grants to instruments which only credit investments.

CONCLUDING REMARKS: THE TRAP OF MONETARY UNION AND FURTHER POLITICAL CONSEQUENCES

The European currency was created too early, that is without adequate deepening of political integration of the Old Continent. Political ambitions (as well as geopolitical ones) were of higher importance compared to economic

circumstances. At the same time, the deficiency of political integration prevented the economic dysfunctions from being subsided by proper redistributive mechanisms. This is how the system of common currency became an „developmental trap” for the peripheral countries. After the initial time of prosperity it has brought them a series of painful costs stemming from the structural disparity of Euroland countries as well as from the asymmetric relations of the authority within the monetary union. Defective institutional structure of the euro zone proved to be also a „trap” for the central states in times of crisis. Costs and economic risk in the Euroland (that are increasingly affecting the central states) are growing exponentially. The strategy of shifting the costs of stabilizing the system onto the politically weakest members of the monetary union has its limits. In this situation the system of common currency is subjected to great political tensions both on part of the central states (and their societies) as well as peripheral countries. Since radical regime reforms are obstructed, the above mentioned political tension and economic costs lead to the decomposition of euro zone.

The period of crisis can be both an opportunity and a serious threat to the durability and development of any political system. The quality of the elites and the institutions of this system has a fundamental value. It is hard not to be under the impression that the ability of the common currency system to reform itself is little. In particular, the remedy for the weak economic growth in Europe has not been found. On the contrary, the fiscal consolidation-related recipes used during the crisis drove several eurozone countries into a long-term recession. The growing pressure on reduction of EU cohesion policy is now becoming visible. It is connected with the introduction of further bureaucratic difficulties in the use of those funds within the cohesion policy framework.

Social costs of the upcoming phases of the economic crisis that Europe is facing seem to be enormous. Those will grow rapidly in case the scenario of uncontrolled disintegration of the common currency is set in motion. It is likely that populist and anti-system social discontent is going to intensify. Some of them will be aimed against European integration which is the foundation for the actual political order in Europe. The crisis may also evoke a series of conflicts among European states. We should keep in mind that if power is captured by euro skeptic elites the disintegration of euro zone (but also other disintegrative consequences such as secession from the EU) may come even sooner. We may already observe symptoms of distancing from further European integration. United Kingdom’s attitude can serve as an example here as it makes use of numerous exclusion clauses to EU resolutions. As the changes to the treaty are being prepared, UK as well as any other member state can base their approval for changes on further concessions and exclusions.

Other consequence of the present crisis would be the growing role of the biggest member states in integration processes, especially Germany and France.

Prolonged economic difficulties may serve to further increase their standing and even to reorganize the EU according to the model of the „Concert of Powers” (that was established in Europe after the Congress of Vienna and lasted from 1815 until 1914). Strengthening the mechanisms of intergovernmental management is becoming more evident in the euro zone and it is done at the expense of common institutions such as the European Commission. There are also tendency to realize the concept of two-speed Europe which means forming a strong integrating center based on economic cooperation concerning the common currency. It is important to note that the inner circle of power in the European Union would be based on the intergovernmental model with Germany and France playing the dominant role. The sign of this tendency would be setting the euro zone summits and deciding on Herman Van Rompuy (President of the European Council) to lead this newly formed unit. Differentiating two speeds of Union’s integration would accelerate if partial decomposition of the present euro zone takes place concerning the weakest southern Europe states.

The EU political system has low both management effectiveness and level of social legitimation. The measures undertaken during the last EU summit are aiming at improving the decision processes and enhancing their political legitimation. An attempt to strengthen the nation states competences in the integration processes has been made, including by increasing the role of the intergovernmental management and limiting the EU institutions’ competences. It may improve making the decisions, but it does not guarantee their better implementation. It is due to the difficulties in using the EU institutions on the basis of the new treaty regulations (the *Fiscal Compact*). A side effect of the implemented changes is the strengthening of the EU power hierarchy between the member states and a categorization into two groups: the countries that are in charge of the EU and the ones that apply the previously undertaken decisions. It means that restoring the sovereign influence on the EU decisions is taking place only in the strongest member states. At the same time it increases the democratic legitimation within the confines of their national political communities. As to the rest of the countries, their sovereignty range is being actually limited. Thereby, their democratic legitimation for the decisions made at European level is reduced.

Another consequence of prolonged difficulties of the common currency is the deteriorating geopolitical standing of Europe on the world scene. The influence of China and other powers will increase on the Old Continent. For years a particularly active and consistent policy in this respect is carried out by China. This proves their growing ambitions to play the role of a world power. What is more, it shows the desire to replace the influence of the USA with Chinese influence around the world as well as in Europe.

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Summary

The European currency was created too early, that is without adequate deepening of political integration of the Old Continent. This is how the system of common currency became an „developmental trap” for the peripheral countries. Defective institutional structure of the euro zone proved to be also a „trap” for the central states in times of crisis. Costs and economic risk in the Euroland (that are increasingly affecting the central states) are growing exponentially. In this article I present major consequences for EU Cohesion Policy as well as other political and economic outcomes of euro zone crisis.

**Pułapka Unii Monetarnej – konsekwencje dla Polityki Spójności UE
oraz wybrane skutki polityczne i społeczne**

Streszczenie

Unia monetarna w Europie została powołana zbyt wcześnie, bez odpowiedniego pogłębienia integracji politycznej. W rezultacie system wspólnej waluty stał się pułapką rozwojową zarówno dla państw peryferyjnych, jak i centralnych Unii Europejskiej. Niniejszy artykuł przedstawia główne konsekwencje politologiczne, ekonomiczne i społeczne kryzysu w strefie euro, ze szczególnym uwzględnieniem skutków tego kryzysu dla polityki spójności UE.