Whither European Economic Governance?

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Abstract
This paper develops a new governance scheme for a stable and lasting European Monetary Union (EMU). I demonstrate that existing economic governance is based on flawed incentives especially due to insufficient macroeconomic coordination, failures of institutional enforcement and animal spirit in financial markets. All this caused the European sovereign debt crisis in 2010. Consequently, the EMU crisis is not a conundrum at all rather a failure of national and supranational governance. To tackle this problem, I propose a return to flexible but compulsory rules driven by market forces. The new governance principles shall promote the compliance and effective enforcement of rules.

Keywords: economic governance, eurozone, euro crisis, animal spirit

1. Introduction
Since 2010, the European Monetary Union (EMU) is in an economic and political crisis. The recent rescue packages were necessary to mitigate the liquidity problems of financial institutions and to stabilise the real economy in the Eurozone. However, there is a lively debate whether this strategy will lead to sound economic governance in Europe (Jonas, 2006; Herzog, 2011). The short-term rescue philosophy might trigger the wrong developments needed for a long-term solution (The Economist, 2011). Indeed, I argue that following the recent policy agenda rather lead to a future break-up than a lasting monetary union. Therefore, I propose a new and effective governance scheme that solves the past and current problems. In the end, only a return to flexible but binding and enforceable rules is an effective solution.

Of course, a first-best solution requires a governance scheme guided by market forces. Though, the first-best option is neither achievable nor realistic in Europe. Hence in a second-best scenario, the governance scheme should follow decisive rules and at least imitate the role of market forces. I will follow this line, which is a unique idea in the literature of governance and a smart solution for the Eurozone. The flawed incentives that allowed this and other crises to emerge illustrate the proposed rule design.

In section 2, I show that the present rescue plan does not solve the fundamental problems and is unsuitable to tackle the long-run issues of the EMU. Moreover, it is common knowledge that the European integration process and rescue facilities are driven by path dependency which, however, is insufficient to tackle the huge structural problems. Thus, the inherent policy action in the past years put EMU comprehensively at risk. Actually, the occurrence of new stabilisation facilities and programmes demonstrate that EMU is at a crossroads.

There exists a consensus that good governance is a prerequisite for a successful and sustainable currency union (Escolano et al., 2012; Schuknecht et al., 2011). Sustainable economic governance does not need too many rules. On the contrary, it requires effective rules and a depoliticised or automatic enforcement that is driven by market forces. No doubt, the past crisis has transformed European economic governance. There are several new institutions for instance the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM) that further reduce the incentives for Eurozone countries to bear the consequences of their own policy actions. Hence, the new institutions will exacerbate negative externalities and moral hazard. Economic literature elucidates that moral hazard incentives are even prevalent in the Eurozone right from the beginning (Beetsma & Bovenberg, 1999; Beetsma & Uhlig, 1999). Although Eurozone member states have agreed to strong economic governance, there are internal reasons to circumvent them.
In section 3, I develop a new scheme of economic governance that is necessary and sufficient for a lasting monetary union. Apart from rules driven by market forces, I suggest an incentive based structure to enhance macroeconomic competitiveness. The performance of the existing governance is ineffective due to a lack of incentives and domestic reservations for painful but needed structural reforms. If policy-makers are unable to establish either a political union or a federal union with pure market forces, i.e. a first-best solution, I suggest a second-best option: a gradual loss of (political) power for those countries that refuse the new binding governance principles of EMU. Finally, section 4 concludes the paper.

2. Method and Results

Since the 1990s and the endorsement provisions of the Maastricht Treaty, a discussion has taken place about the design of economic governance in accordance to the Optimum Currency Area theory. Although economic governance has failed in past monetary unions, I argue that an enforceable governance scheme aligned with market forces can be effective. A rigours study of the past failures in the Eurozone allows us to identify the lessons and necessities of good governance in a monetary union.

2.1 Flawed Macroeconomic Incentives

Herzog and Hengestermann (2013) demonstrate that the optimum currency area literature underlines several desirable features of economies wanting to share a currency. However, the current framework in EMU lacks on effective and enforceable rules. There are too many loopholes in the governance scheme of today. Apart from this finding the optimum currency area (OCA) literature has also critics. Robson (1987) and Tavlas (1994) note that OCA criteria are difficult to measure and have a ‘problem of inconclusiveness’, as criteria may point in opposite directions. Nonetheless, the endogeneity of OCA theory has strengthened the potential benefits of a monetary union. Frankel and Rose (1998) anticipate that the positive side-effects of the euro might become apparent after 20 to 30 years.

Next, I will argue that the current crisis has not emerged due to the weaknesses of OCA theory rather due to economic failures and flawed macroeconomic incentives. Since the Lisbon strategy in 2002, the European Union (EU) has endorsed economic reforms to eliminate existing malfunctions in European governance. Due to varying incentives, Eurozone member states have been working continuously on their economic and fiscal weaknesses, however, with different levels of commitment and speed. For instance Germany and Finland have adapted labour market reforms despite severe domestic reservations. Other Eurozone countries, however, have done almost nothing. For the first time since decades, many Eurozone countries enjoyed attractive credit conditions provided by even negative real interest rates. Thus, public and private debt accumulation was in vogue and the declining pressure to execute economic reforms eroded the competitiveness of the countries concerned continuously. In the end, this behaviour has contributed to the divergence in the current account balances of the Eurozone (Figure 1).
Economists have discussed the handling of uncontrolled reversals of current account imbalances for more than two decades. Figure 1 shows the expanding imbalances until the financial crisis of 2007–2008 and thereafter a gradual decline. The hidden forces behind this economic trend are the flawed incentives in macroeconomic governance. A closer look to Figure 1 reveals that Spain, Italy, Greece and Portugal were the biggest deficit countries, and Germany and the Netherlands are the major surplus countries. The current account of the other deficit or surplus countries is negligible. If we calculate the current account in respect to GDP, we immediately identify Greece, Portugal, Spain and Ireland as the biggest deficit countries again.

Ireland and Spain are two special cases because both had rather sound public finances before the onset of the financial crisis. The problem in Spain and Ireland is their relatively high private debts. Consequently, both economies experienced an unsustainable investment and housing boom due to flawed macroeconomic incentives via negative real interest rates from 1999 to 2006 (Herzog, 2012). The build-up of an asset bubble in Spain and Ireland as well as the inefficiency of public administrations and debt accumulation in Greece, Portugal and Italy demonstrate the flawed incentives. Hence, the sovereign debt crisis is not merely the consequence of insolvent banks and the burst of the bubble; it rather reflects governmental ignorance of enforcing the rules and conducting the necessary reforms.

In addition to this problem, there is a substantial decline in competitiveness in the five troubling countries of the Eurozone. Wages rose faster than productivity for years, meaning that their unit labour costs, relative to their major rivals, were about 20 per cent higher than in 2000 (Figure 2).

![Figure 2. Unit labour costs of selected Euro area countries (Index 2000 = 100)](image)

Source: Author, data Eurostat.

Given that all countries are unable to make adjustments of the nominal exchange rate, the only way out are painful wage cuts. This does improve competitiveness but exacerbates the debt problems of private households. Moreover, it turns out that the gap in unit labour costs is caused by the wrong macroeconomic incentives rather than low productivity (Table 1). Simply, national wages rose faster in relation to domestic productivity dynamics due to flawed wage setting procedures.

<table>
<thead>
<tr>
<th>Countries</th>
<th>Annual average between 2000 and 2010 in per cent</th>
</tr>
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<tbody>
<tr>
<td></td>
<td>Productivity</td>
</tr>
<tr>
<td>Germany</td>
<td>0.7</td>
</tr>
<tr>
<td>Spain</td>
<td>1.1</td>
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<tr>
<td>Greece</td>
<td>1.9</td>
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<tr>
<td>Ireland</td>
<td>1.7</td>
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<tr>
<td>Portugal</td>
<td>0.6</td>
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Description: own calculations based on Eurostat data.
There is even empirical evidence that deficit countries increased wages more than surplus countries (EU-Commission, 2012). This fact illustrates again that economic governance has failed due to flawed macroeconomic incentives, missing rules and market forces. Despite some macroeconomic improvements in recent years there is almost no significant improvement in terms of competitiveness in Italy and France (Sachverständigenrat, 2012).

2.2 Flawed Institutional Incentives

Founding the EMU has fundamentally changed the structure of European governance especially monetary and fiscal interaction. All member states’ debt is now denominated in euro, without the possibility of a respective central bank to create the means to repay the debt. European Member states just supposed that the spill-over risk of default is eliminated by institutional rules, such as the no-bailout clause and the Stability and Growth Pact implemented in 1993 and 1997 respectively. These fiscal rules guarantee that unsound fiscal policy and thus default is in national sovereignty. However already in the 1990s, economists realized that the no-bailout clause is almost incredible due to free-riding and moral hazard incentives in the Eurozone (Beetsma & Uhlig, 1999). Hence, in situations of severe turmoil it was expected that the rules will be abandoned (Hellwig, 2011).

I illustrate the institutional failures by studying the Stability and Growth Pact (SGP) in detail. The pact stipulates that budget deficits and national debts must be below of 3 per cent and 60 per cent of GDP respectively. Moreover, in medium term a balanced budget is a mandatory target for all EU member states. Unfortunately, there are approximately 60 breaches of the SGP and none of them has triggered any defined consequences. According to Herzog and Hengstermann (2013), ‘the pact’s Achilles’ heel was its weak enforcement provision and non-existent pre-emptive function.’ Indeed, the past experience confirms both a fundamental lack in political will to act and flawed incentives in the enforcement of European governance (Fischer et al., 2006; ECB, 2008; 2010). There are several reasons for the weak enforcement: First of all, the opening of the pact’s procedure needs the backing of the EU Commission. In a second phase a qualified majority in the Council of the Economic and Finance Ministers (EcoFin) must approve the next steps. But the intergovernmental formation of the EcoFin council delays decision-making automatically due to heterogeneity of member states and diverse macroeconomic incentives. Furthermore, EU countries that ‘sinned’ retained the right to vote. In the past, the voting of those countries was almost always against the founding principles of sound finances, i.e. they blocked any enforcement of the excessive deficit procedure according to the EC regulations 1466/97 and 1467/97. An excellent case study is Germany, France and Italy in 2003 to 2004. They all breached the 3 per cent deficit limit of GDP, however, despite the unambiguous provisions in the excessive deficit procedure, the EcoFin Council could not even agree on sending an early warning to these countries. Consequently, as long as all countries are part of the decision-making procedure, especially in case of noncompliance with the pact’s provisions, EMU’s economic governance is doomed to fail.

The past experience of rule enforcement in the Eurozone reveals that the procedures do not enable countries to internalise welfare costs and benefits in future; e.g. The impact of debt accumulation or structural reforms. In fact, it does not make any sense for a country to encourage sanctions for countries breaching the deficit threshold if you could be the next violating the rule. By the way, this experience coincides with the policy lessons in historical monetary unions of the past two centuries (Bordo & Lonung, 1999). They even show that the break-up of past monetary unions is mainly due to the fact of poor governance.

Unsurprisingly, the architect of the pact, a former German finance minister, argued in favour of an almost automatic enforcement of the excessive deficit procedure. Fischer et al. (2006) summarize all existing possibilities to tackle the existing enforcement problem of the Stability pact. In general, there are two possibilities: Either the delegation of the decision-making to an independent council or an automatic voting scheme. The first idea of an independent council can be accomplished on lines of the Swedish Fiscal Policy Council (Calmfors, 2010). The second idea requires a change of the existing voting mechanism within both the SGP and the overall economic governance provisions. The new voting scheme would reduce the voting weight automatically for Eurozone members with deficits and debts above 3 per cent and 60 per cent of GDP respectively. Thus, the voting scheme follows the idea of policy-rules such as in monetary policy (Taylor, 1993). The proposed voting mechanism leads to a loss of sovereignty only in case of continued violation of the pact’s provisions (Herzog, 2005). This way, the voting scheme links political power to its current policy performance in light of the rules. The advantage of this governance scheme is three fold: A) it is like an insurance premium for sustainable member states. B) The voting scheme internalise the potential welfare costs of domestic policy decisions; and C) the loss of voting power, and thus sovereignty, provides an intrinsic incentive to national policy-makers to behave according to the mandatory rules in the Eurozone. Moreover, this incentive is stronger than the existing incentives of the sanction fee today (Herzog, 2011). Consequently, Eurozone members that
respect the pact’s provisions will have wide-ranging fiscal and economic sovereignty, while the flouting of the pact’s principles will lead to a loss of sovereignty for the countries concerned.

Unfortunately, the current fiscal governance scheme rewards cheating. Hence, countries reject cooperation within the existing rules and gets away with it. Thereby other member states will be encouraged to flout the rules as well. Of course, this is an old phenomenon and well-known in the literature of public finance. Indeed, there are always incentives to overspend in fiscal policy due to the electoral business cycles and partisan behaviour (Nordhaus, 1975; Alesina & Tabellini, 1987). Furthermore, these incentives are even amplified in a currency union due to free-riding (Beetsma & Bovenberg, 1999; 2000; Dixit & Lambertini, 2003). Consequently, policy-makers in a monetary union have relatively few incentives for sound public finances. At the moment, the flawed institutional incentives unravel the economic governance scheme at all, and even create the famous Prisoner’s Dilemma. Eventual, we get a collapse of the euro due to the flawed institutional incentives.

In addition, the current Stability pact overemphasis public deficits rather than long-run public debt and does not focus on both public and private debts equally. The reasons for both shortcomings are political economy arguments. First, a deficit is easier to observe and monitor than debts. Second, measuring sustainable debt levels require crucial assumptions and thus strong political value judgements. Third, the focus on just public debt levels is a design defect and demonstrates why Ireland, for instance, has not appeared on the radar screen of the European economic governance in the past years.

Herzog and Hengstermann (2013, p. 7) demonstrate the features of efficient governance and effective fiscal rules as one solution for the flawed institutional incentives. Even if recent reforms in fiscal and economic governance pointing in this direction, they are neither sufficient nor well designed for a long-run stabilisation of Europe. Actually, the gradual transformation of existing governance in EMU confirms rather path dependency in Europe. There is no doubt, that the economic and cultural heterogeneity of EMU muddles the construction and execution of good governance. Hence, I argue that good governance has to respect sovereignty concerns and cultural heterogeneity at any time. So, the challenge is the design of European governance across independent countries within a supranational context. Such an approach requires at least two issues: A) permanent incentives to avoid moral hazard and free-riding and B) a link of supranational and home governance. Unfortunately EMU’s current governance, is putting all governments and the EMU at risk.

2.3 Flawed Financial Market Incentives

During normal times financial markets have not differentiated sufficiently between the creditworthiness of euro area countries. This is astonishing because the legal and institutional setting puts unambiguous responsibility to domestic policies. Despite clear national responsibilities, markets disbelieved the European rules since the beginning of the EMU in 1999. This “irrational” market behaviour remains partly unsolved. However, the insufficient macroeconomic and institutional incentives aligned with animal spirits in financial markets explain this issue sufficiently. Next, I elaborate this argument in further detail.

Fortunately, since 2010, the financial markets responded with a reasonable assessment of creditworthiness, competitiveness and sustainability of Eurozone countries. However, the relative abrupt reversal of the financial market assessment has produced a situation similar to a bank-run. These self-reinforcing and systemic effects are highly contagious; i.e. they create temporary liquidity problems and evolve into enduring solvency crises in some countries.

According to standard theory in finance, bond spreads reflect default risks, and default risk is determined by a number of fundamental variables such as government debt-to-GDP or the current account. The theory states that a higher government debt-to-GDP increases the burden of debt service and thus increases the probability of default. Hence, the bond spread widens because investors demand a higher risk premium to compensate for the higher default risk. A similar effect occurs for a larger current account deficit because it could be interpreted as an increase in net foreign debt of a country.

Between 1999 and 2010 the bond spreads in the Eurozone were almost zero, despite the empirical divergence in the current account balances and public debt levels (Figure 1). Then, since the beginning of the euro crisis, spreads of government bonds widened significantly. But the increase in spreads was significantly larger than the changes in the underlying fundamentals (De Grauwe & Ji, 2012). This raises the question whether the financial markets may have mispriced risks or whether the orthodox bond theory is not applicable to a monetary union. The obvious disconnect between bond spreads and fundamentals are proven for several Eurozone countries such as Portugal, Italy, Greece and Spain.
The economic rationale behind the flawed incentives of financial markets in EMU is equally trivial and obvious. In contrast to stand-alone countries, euro area member states do not have control over their own currency and thus cannot guarantee the pay-out of the bondholders. The institutional linkage to the supranational framework especially monetary policy eliminates the disciplinary effects of free market forces. The European Central Bank (ECB) sets a common interest rate for 17 euro area countries and thus triggers either positive or negative stimulus dependent on the stage of the business cycle. This unique interplay between national fiscal policy on the one hand and supranational monetary policy on the other hand, characterises the specifics of the sovereign bond markets in the Eurozone. In times of market stress, the divide of domestic fiscal policy and monetary policy is an important vulnerability. On the contrary, stand-alone countries, such as the UK, the US or Japan face continuously more market pressures in the run-up to the crisis. Moreover, they have all domestic policy measures to tackle immediate problems because they are domestically responsible for all monetary, financial and economic matters.

Herzog and Müller (2013) build a model in line with De Grauwe (2012) and demonstrate the impact of flawed financial incentives. Suppose there are two types of traders, optimists and pessimists. Optimists (pessimists) have the tendency to overestimate (underestimate) the bond price. Thus, the market price is different in both groups of traders. The optimists believe that , and the pessimists believe . In this respect, and is the true, but unknown, bond value. The bond demand functions are

\[ D_{opt,t} = \alpha (b_{opt} - b_t) \]

\[ D_{pes,t} = \alpha (b_{pes} - b_t) \]  

where . Moreover, the market-maker collects the individual orders of both types of traders , where is the type (1 = optimist and 2 = pessimist) and is the time period. The market value of a bond is computed by a standard forward equation

\[ b_{t+1} = b_t + \gamma \sum_{\omega_{i,t}} D_{i,t} \]  

where measures the speed with which the market-maker adjusts the bond price. In addition, I use the definition of , with to rewrite the weighting factors, such as and . Substituting both definitions and the demand equations (1a, 1b) in equation (2), results in:

\[ b_{t+1} = b_t + \alpha [b^* - b_t + x\zeta_t] \]  

Let me discuss the intuition of this equation. The variation of the bond price between two consecutive periods relays on two factors: (1) the price gap between the fundamental and today’s value and (2) the portion of pessimists and optimists, . Thus, the bond value increases (decreases) if its fundamental value is above (below) the price of today. The same effect happens, if , i.e. the quantity of optimists is greater than pessimists; and vice versa for . Interestingly, the impact of tomorrow’s bond value is also dependent on the degree of price expectations between both types of traders. Finally, I close the model via modelling the dynamics of traders. Traders do not choose their trading strategy randomly rather on pure rational criteria. If the rule turns out to be beneficial–maximise profits–they stick to it. The profit function of the optimist and pessimist is simply defined as the price change times the quantity or: . The numerical simulation of this behavioural model illustrates an important insight: During booms or busts there is animal spirit in financial markets which mean there are either more optimists or pessimists. This imbalance will cause the markets to overreact either positively or negatively (Figure 3).
This phenomenon is predominant in bond markets under turmoil and even amplified in the European monetary union due to flawed institutional and macroeconomic incentives. Hence, this model explains sufficiently the sudden change and behaviour of financial markets during the bond market turmoil in 2010. Altogether flawed incentives and animal spirits contributed to the market turmoil in Greece, Portugal, Spain, Ireland and Italy. The systematic disconnection between bond market fundamentals and the respective bond yields is triggered by flawed supranational governance, high asymmetric information and weak reputation in public finances (Herzog & Müller, 2013). Thus, it is not remarkable that stand-alone countries with debt-to-GDP ratios equally high or even higher than Eurozone members were not affected by a similar debt crisis. On the contrary, the existing flawed incentives and irresponsibility in EMU’s governance has contributed to further domestic free-riding and moral hazard. Altogether, this may give evidence that mispricing of sovereign risk is augmented in the European Monetary Union. Consequently, financial markets are more fragile, vulnerable to self-fulfilling crises, and display less disciplining incentives in the Eurozone of today.

The policy lesson is simple: A monetary union only works efficient if its institutional setup is based on market incentives and considers the effect of animal spirits sufficiently. Thus, effective governance driven by market forces is a solution for the Eurozone. The proposed governance scheme has to imitate market forces and prevent animal spirits, such as free market forces do automatically for stand-alone countries.

3. Discussion

In this section, we propose a new economic governance scheme for the EMU. The major problem in the Eurozone is the weak and non-credible economic governance scheme including both insufficient market and enforcement incentives. My governance scheme is designed according to public goods theory (Coase, 1960; Alesina & Tabellini, 1987). In order to design good economic governance for completely different as well as independent countries, we distinguish two models in general.

Model A represents a hierarchical system and is a major modification of the current policy and institutional structure. This model transfers almost all sovereignty over both economic and fiscal policy on the supranational level and thus needs a fundamental change of both domestic and European law. Indeed, the transformation of the Eurozone towards this model would be long and sophisticated. As long as there is no wide-ranging public support and political will for this direction in Europe, it is not a realistic option.

On the contrary, model B is an effective and enhanced governance scheme aligned with market forces. This is closer to the current institutional setup and therefore more likely. It would strengthen the incentives and mitigate existing externalities for countries with sound policies. Hence, model B entails a return to the spirit of the Maastricht Treaty. Clearly, this governance model needs more European coordination as well. The crucial elements are developed in Herzog and Hengstermann (2013).

The overall spirit of model B is that Eurozone member states bear 100 per cent responsibility for all domestic policy measures. Therefore, neither model can work unless the guiding principle of responsibility and control which rests in the same hands is re-established. This implies a credible no-bail-out clause according to Article 125 EU-Treaty and the mandate for monetary policy to abide the prohibition of monetary financing (Article 123
EU-Treaty) in all—even extreme—cases. Apart from a new governance scheme which enables the internalisation of macroeconomic differentials, we have to get rid of the arbitrary incentives of financial markets.

Overall, both models are appropriate to tackle the current challenges. However, a combination of model A and B, that is, sharing the costs of unsustainable policies while retaining sovereignty, is expected to fail. This is the major underlying policy problem of the today’s rescue packages. All recent emergency facilities provoke moral hazard incentives and furthermore erode European economic governance. The proposed governance in model B, however, is aligned with both market incentives and automatic enforcement mechanisms. In addition, this new mechanism requires a tough monitoring procedure right from the beginning and regularly thereafter. Consequently, the new governance scheme of model B replicates the market forces of stand-alone countries and enhances the effectiveness of the ex-ante conditionalities of EMU’s rules.

In Europe of today, the greatest policy failure is the execution of tough austerity programmes ex-post, and not ex-ante. Consequently, existing governance in Europe puts the wrong incentives at the wrong time. Likewise, the new governance mechanisms must strengthen pre-emptive incentives and the purpose of democratising Europe. Thus, the new policy environment is effectively enforced on the domestic level as long as the country acts in accordance with supranational rules (Oates, 1972); and over this you serve the national needs and democratic spirit at best. But if a country’s policy-maker fails, the supranational level would get more responsibility. That way it would best encourage economic growth for all European citizens.

4. Conclusion

This paper demonstrates that the crisis in the Eurozone is caused by flawed incentives in economic and institutional governance. To restore confidence in the EMU we need both new ideas and approaches in future. The proposed economic governance scheme will restore confidence and shape the currency union towards a better future. Thus, this proposal will not be reversing the European integration process as long as policy-makers return to enforceable rules aligned with market forces. However, any rule breach must trigger a certain loss of sovereignty and thus puts unambiguous incentives to be always in compliance with the supranational rules. This is necessary in the EMU because of obvious moral hazard incentives especially in comparison to governance schemes in stand-alone countries. A simple delegation of the enforcement task to the European Commission does not solve the past failures because even the Commission has failed its role as a guardian of the treaty. Consequently, we need in future both an automatic enforcement and market forces in European economic governance. As long as policy-makers stick to the spirit of model B, however without sufficient incentives to enforce the rules, the Eurozone is doomed to fail.

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