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EURO ZONE CRISIS AND EU GOVERNANCE: TACKLING A FLAWED DESIGN AND INADEQUATE POLICY ARRANGEMENTS

(An Essay)*

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This paper focuses on the roots of strain in the European Monetary Union (EMU). It argues that there is need for a thorough reform of the EU governance structure in conjunction with radical changes in the regulation and supervision of financial markets. The EMU was sub-optimal from its debut and competitiveness gaps did not diminish against the backdrop of its inadequate policy and institutional design. The euro zone crisis is not related to fiscal negligence only; over-borrowing by the private sector and poor lending by banks, as well as a one-sided monetary policy also explain this debacle. The EMU needs to complement its common monetary policy with solid fiscal/budget underpinnings. Fiscal rules and sanctions are necessary, but not sufficient. A common treasury (a federal budget) is needed in order to help the EMU absorb shocks and forestall confidence crises. A joint system of regulation and supervision of financial markets should operate. Emergency measures have to be comprehensive and acknowledge the necessity of a lender of last resort; they have to combat vicious circles. Structural reforms and EMU level policies are needed to enhance competitiveness in various countries and foster convergence.

Keywords: integration, financial crisis, EMU, sovereign debt, governance reform

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INTRODUCTORY REMARKS

The sovereign debt crisis has created enormous anguish in the European Monetary Union (EMU) and emergency measures are used in order to prevent its breakdown. The European Council summit of October 2010 considered a report with a telling name: "Strengthening Economic Governance in the EU". In March 2011, the Council adopted the Euro Pact and the European Parliament approved the "Six pack" measures. A *Treaty on Stability, Coordination and Governance* was signed by 25 governments in March 2012. However, this *demarche* to reform governance is not an attempt to deal with a *terra incognita*. From the very beginning of the euro zone, there was some discomfort with its institutional underpinnings and there were misgivings regarding its optimality as a currency area. This explains why a train of thought underlines a political rationale, too, for its creation. Likewise, criticism over the way regulation and supervision were established in the Union is not of recent vintage. Insufficiencies of the *Stability and Growth Pact* (SGP), with almost all member states flouting its rules at various points in time, were repeatedly pointed out. This said, however, the flaws of financial intermediation have been less considered by policy-makers and central bankers for reasons which, partially, are to be found in a paradigm which dominated economic thinking in recent decades. This paper focuses on the roots of the huge strain in the Union and policy issues ensuing from the current crisis. *Nota bene:* there is a "political reality" which constrains decisions in the EMU; the latter is not a federal structure and what appears to be rational when defined strictly economically may clash with implications of its political configuration.

1. ROOTS OF STRAIN IN THE EMU

The flaws in the design of the euro zone are increasingly acknowledged as the main cause of its crisis. As a keen observer of EU affairs remarked, the founders of the euro zone were aware of its design flaws, but did not find a solution to economic integration without political union (Pisani-Ferry 2011). Its sub-optimality as a currency area is to be mentioned, too. At the same time, the gravest financial crisis since the Great Depression and a redistribution of world economic power complicate the functioning and the repair of the euro zone. Structure is the key in understanding the euro zone crisis and the financial crisis. This should be understood in terms of rules, networks, institutional arrangements and common policies. Structure can derail even brilliantly conceived policies and can shape policies wrongly. For instance, complacency *vis-à-vis* the expansion of financial entities overexposes the economy to major risks (as it happened in Iceland, Ireland, the UK, etc.). Alternatively, take a premature opening of the capital account, as it occurred in numerous emerging economies.

1.1. The EMU: Sub-optimality and institutional and policy weaknesses

Nowhere is the impact of structure more obvious than in the European Union, in the EMU in particular. For in this area, substantial cross border operations take place, while national prerogatives in regulation and supervision, in tax and budget policies basically stay in national hands.

A set of challenges for the functioning of the EMU are rooted in the economics of currency areas. The optimum currency area (OCA) theory (Mundell 1961) contends that the adoption of a single currency pays off when the monetary area is highly integrated economically and institutionally, and has the capacity to adjust quickly to asymmetrical shocks. Traditionally, there are five core OCA properties, namely wage and price flexibility, trade integration, cyclical convergence, factor mobility, and fiscal federalism, which are used to assess an OCA area. In the EU, wage setting continues to be done, predominantly, at the national level, and quite often at the sectorial level. This mechanism reinforces the relative inflexibility of the individual countries' labour markets. Within the euro area, real wages have tended to be downwardly rigid with a relatively high level of indexation. Moreover, although nominal interest rates had largely converged, there was a wide discrepancy among real interest rates of the euro zone members. Although business cycle synchronization has increased within the euro zone countries, much of it had to do with the fall in the amplitude of global business fluctuations, which benefited from low interest rates and low inflation during the past decade – what some called the Great Moderation.

The current crisis highlights the inadequacy of existing institutional and policy arrangements and a stark fact: *that not all problems have a fiscal origin* (though they may end up, ultimately, as public debt). These arrangements have favoured the accumulation of internal imbalances against the background of one-sided, inadequate policy tools. The "one size fits all" monetary policy of the European Central Bank (ECB) could not prevent excessive capital, frequently of a speculative nature, flowing into less developed areas of the EMU, in the EU as a whole. Resource misallocation and bubbles were stimulated in this way. Likewise, an increasing entanglement of mutual exposure among financial entities[1] has taken place, while burden-sharing arrangements in case of a failed entity were missing. After the crisis erupted, the ECB has turned into a *de facto* unwilling lender of last

1 Banks outside of Greece, Ireland, Portugal and Spain hold 2 trillion euro in debt instruments from these countries, which underscores the systemic risk to the financial system if one or more borrower countries fail (data compiled by Jacques Cailloux, cited by Kanter 2010).

resort to various governments, which have tried to prop up financial institutions, be it indirectly (by accepting a wide range of bank collaterals). Contagion effects have reinforced the sentiment that institutional and policy arrangements are more than precarious. Systemic risks, which have been engendered by "too big to fail" cases, have been compounded by the effects of a "too big to be saved"[2] syndrome.

The EMU is the only integrated area in the world which has a centralised monetary policy, but favours a rather local (state) based approach to fiscal policy. The foundation for the latter was laid out in the SGP, which acts as a coordinating instrument. However, all EMU member states breached its rules on one or more occasions. Because the financial crisis has had a very severe impact on national public budgets, the very SGP rules have been put on the shelf. The cost of bank bailouts is staggering and the rise in public debts is worrying.[3] There are several issues for debate in this regard. One relates to what could evolve as an unsustainable indebtedness of the EMU area. If the cumulated budget deficits (in the EMU), together with private sector indebtedness, turn into a substantial external current account deficit for the euro area as a whole, while its flaws persist, this situation would damage the status of the euro over the longer term.[4]

Another aspect of the EMU debt problem concerns the relationship between those economies which are running surpluses on their current account (primarily Germany) and those which are running persistent large deficits (such as Portugal, Italy and Greece). This financial crisis has shown the internal tension which such an uneven distribution of competitiveness (as a lack of sufficient convergence) in the EMU creates.[5] This inner major weakness has to be dealt with if the euro area is to avert highly damaging cracks. Given the existence of a common monetary authority, the ECB, and insufficient convergence in the euro zone, the argument for an EMU fiscal authority is compelling. This would create more room for manoeuvre for the mechanisms of fiscal transfers in the face of idiosyncratic shocks. It would also place less pressure on the ECB when dealing with regional divergences.

The regulation and supervision of financial markets is a huge policy issue in the EMU, in the EU in general. The distribution of responsibilities between home

[2] The overexpansion of some financial entities has dwarfed the capacity of home states to intervene in order to deal with systemic risks (Gros – Micossi 2008).

[3] Apart from the effects of the current financial crisis (the cost of bail outs and big rises in government borrowing), another threat to sound public finances is the ageing of population. Reforms of the welfare systems are a must under the circumstances.

[4] One would have to factor in the crowding out effect large public debts would exert on domestic business, which would damage private investment and, consequently, economic growth in the EU.

[5] For diverging competitiveness in the euro area, see also EMU at 10 (2008).

and host country and the inexistence of detailed burden-sharing arrangements in the event of a crisis has been a major handicap for the single market under conditions of deep financial integration.[6] Under current arrangements, responsibility for the stability of financial institutions belongs to the supervisor of the country where they are headquartered, whereas responsibility for the stability of financial systems belongs to the supervisor of the host country. This crisis reinforces the idea that a common rulebook, more integrated supervision, and a common framework for crisis resolution are all needed to match the degree of financial integration. On the other hand, the burden-sharing issue prompts national governments and supervisors to think more along national lines in view of their accountability toward national taxpayers.

The bottom line is that in order to function properly, be viable, the EMU should have solid fiscal/budget underpinnings; the latter would imply a common budget (common treasury) and the issuance of joint bonds – as in federal states (US, Canada, Germany, etc.) when seen as monetary unions. Likewise, a common regulation and supervision of financial markets would make sense in the EMU.

Failures in policy action

In the face of crises, the European institutions have almost always had a reactive approach, doing just enough to fix the problem in the short term. Still, most of the time, decision-making has been too little and too late. At the root of this cause are conflicting national interests and inadequate institutional and policy arrangements. The two previous notable European initiatives, the Lisbon Strategy and the SGP, have both largely failed because rules enforcement was weak, not to say largely inadequate. With domestic interests at stake, peer governments loathed penalizing each other. Proposals of automatic sanctions, triggered in the event of breaching the rules, have been consistently ignored. Another reason why these initiatives failed is because they minimized the role of major discrepancies among member countries at various levels: structural, economic and political, and the cost incurred to fulfil the stated objectives.

6 The de Larosiere et al. (2009: 76) report notes, "The absence of a sound framework for crisis management and resolution (with sufficiently clear principles on burden sharing, customers' protection, assets transferability and winding up) complicates the introduction of an effective and efficient supervisory system to avoid financial crises in the first place."

1.2. The global context: The financial crisis and power redistribution

A financial system gone astray

Financial stability has staged a formidable comeback on the policy-making agenda in advanced economies. The current financial crisis has exposed flaws in the working of financial markets; this crisis cannot be explained only by years of cheap money and growing imbalances in the world economy. Mistakes in macro-economic policy were accompanied by gross abuses of securitization, excessive leverage, abnormally skewed incentives and a loss of moral compass, inadequate risk-assessment models and failures to check for systemic risks, a breakdown of due diligence and an almost blind belief in the self-regulating virtues of markets.

Financial intermediation, as it has evolved during the past decades, proves that not all financial innovations are good, that inadequate risk and business models have been used by banks and other financial institutions. Quite a while ago, warnings were sent regarding the growing opaqueness of markets due to securitization and off balance sheet activity. Lamfalussy (2000: 73) noted that financial integration made "crisis prevention and handling it more difficult"; unregulated financial markets have turned into an *in-built destabilizer*. Moreover, the financial industry has become oversized in more than a handful of economies.

The paradigm shift which is currently underway is rediscovering systemic risks. The complexity and inter-connectedness of financial markets enhance contagion effects and invite "Minsky moments".[7] But there is need to make here a distinction between two opposed cognitive approaches: one that believes that nothing can be done about the evolution of markets, whichever way financial innovation goes; and another approach, which does not take the complexion of markets as God given and has misgivings about a range of financial innovations. Networks do not mushroom accidentally only; they are also shaped by policies. As Haldane (2009: 31), the Director of Research at the Bank of England remarked: "Deregulation swept aside banking segregation and, with it, decomposability of the financial network. The upshot was a predictable lack of network robustness."

Prior to the financial crisis, European leaders failed to recognize the extent to which European banks were involved in the origination and distribution of toxic

[7] These are moments when, according to Minsky (1986), financiers lay waste to the economy. A "Minsky moment" comes after a long period of boom, after much speculation via borrowed money; it happens when over-indebted investors are desperate to sell good assets to pay back their loans, causing huge drops in financial markets and big surges in demand for cash. Paul McCulley of PIMCO coined the term to describe the Russian financial debacle of 1998 (Lahart 2007).

financial products. Financial sector practices have also obscured the size and dangers of the shadow-banking sector in Europe. This crisis is also one of deep financial integration in the absence of proper institutions and policies, which the intensity of the sovereign debt crisis mirrors glaringly.[8] In Europe, integration, with its financial component, was seen as a way to achieve catching up. This approach entailed benefits, but it has also caused vulnerabilities, which are not to be linked with weak policies exclusively. For even countries which were quite prudent policy-wise and limited their external disequilibria were caught into the crisis maelstrom. Big bubbles and much investment in non-tradable goods sectors occurred in several New Member States (NMS) following the opening of the capital account.[9] Inadequate regulatory and supervisory arrangements operate in their case, too, against the backdrop of massive cross-border financial flows and the domination of local markets by foreign banks. Outside Europe, emerging economies strove to learn from previous crises and tried to forestall shocks by the accumulation of foreign exchange reserves as a buffer (a high premium was attached to them); uphill financial flows were seen as a purposeful cost for the build-up of a wherewithal capacity in the advent of unanticipated shocks.[10] Industrial policy aims, too, played a role in this respect.

Redistribution of power in the world economy and global imbalances

The *Lisbon Agenda* was enacted in 2000 as the EU's response to Asia's growing assertiveness in the world economy. *Europe 2020* is a resuscitation of that Agenda. One of the lessons of the past decade is that national policies do make a difference. The results of Scandinavian countries and of Germany in undertaking pro-competitiveness reforms are proofs in this regard.

Global imbalances enhance crises, which produce contagion effects. Can the EU push for a reform of the International Financial Institutions (IFIs) and of global arrangements to limit dangerous global imbalances? In our view the EU would gain in persuasion and bargaining power in the G20 to the extent it can deal with its own problems effectively. Yet, conflicting views and interests among the Member States reduce the internal cohesion and harm its power projection exter-

8 Reinhart and Rogoff's (2009) observation that deep financial crises are followed by sovereign debt crises is quite meaningful in the case of a highly integrated monetary union.

9 A Bruegel publication highlights this type of capital flow into the Baltic economies, Romania and Bulgaria (Becker et al. 2010, especially chapter 2).

10 There is, arguably, an optimal degree of financial integration in the global economy in view of destabilizing capital flows (see also Stiglitz 2010). A legitimate question is what should be done in the EU about it, since unhindered capital flows are a rule of the game in the Union.

nally. In addition, the heavy dependence of euro zone Member States on financial assistance of the IMF (up to 80% of its total lending) does not enhance the EU status in G20.

2. DECEPTIVE AGGREGATE DEFICITS IN THE EMU: WHY THERE IS NEED FOR A FUNDAMENTAL REPAIR

Top officials of the ECB and the EU note recurrently that the aggregate deficit of the euro zone is smaller than that of the US or Japan. By this assertion they want to underline that the overall state of the euro zone is not worse than that of the US, or of other major economies; and that, consequently, it should not cause a bigger worry. It is true that the US' public debt, which has come close to 100%, is above the aggregate level of the EMU; and the latter's budget deficit was 6% of GDP in 2010, whereas the figure for the US exceeded 9%. Japan has a public debt over 200% of its GDP. However, these numbers need to be judged in conjunction with the roots of the euro zone crisis, of the sovereign debt crisis in the EMU. Although the level of aggregate public debt does matter, the main cause of the euro zone crisis lies elsewhere, in its poor design. Until the eruption of the current financial and economic crisis, this flawed construction was obscured by markets' myopia.

Economic history, of longer and recent vintage, is most instructive in this respect. Let us think of what differentiates the US, as a federal structure, from the euro zone. A US sovereign debt crisis cannot be ruled out, in the long run, where its public debt continues to grow and markets lose confidence in the US dollar as a reserve currency. But an "American crisis" would rather occur as a massive depreciation of the US dollars, which would entail high domestic inflation. For the foreseeable future, American T-bills and bonds are among the safest investments in the world. Nobody assumes the disappearance of the dollar, while quite a few people are worried about the fate of the euro zone (and implicitly, of the euro), and various scenarios are imagined in this regard. Moreover, markets have already priced in, more or less, tail events (default), contagion, linkages between sovereign debt and bank balance-sheets in the euro zone. Were an American state threatened by bankruptcy, hardly anyone would doubt the existence of the USA as a monetary union. Bank recapitalization in the US has proceeded better and more transparently than in Europe, and there are federal institutions for the regulation and supervision of financial markets on the other side of the pond. That their functioning has been inadequate, not least because of waves of deregulation (including the rescinding of the Glass – Steagall Act of 1999 and the Commodity Futures Modernization Act of 2001), is an entirely different matter. The US "single market" functions better than in the EMU. Such examples could be continued.

A telling argument showing that markets do not pay much attention to EMU's "aggregate" numbers is that since the start of the current crisis, they have increasingly discriminated among the sovereign debt of euro zone member countries. The interest rate convergence of the past decade was, arguably, a market myopia, a market failure, which brought about over-borrowing by state and private sectors as well as massive resource misallocation. This crisis was a wake-up call, though this is happening with damaging overshooting, panics and vicious circles. Another question can be illuminating on aggregate numbers: how much fear-mitigating would be a diminishing external deficit of the euro zone were it accompanied by a growing cleavage, competitiveness-wise, between Germany, the Netherlands and the periphery (Greece, Portugal, Spain and Italy) in the euro zone? As this crisis shows, external imbalances matter in the EMU, too.[11]

The setting up of the European Financial Stability Facility (EFSF) proves the weakness of aggregate numbers as an argument. An analogy could be made between the American Toxic Assets Recovery Program (TARP) and the EFSF. TARP aimed at propping up financial entities; it was not set up because of the threat to the US as a monetary union. Instead, there are undisguised worries regarding the future of the EMU. Further, the very operations of ECB, of buying sovereign debt of member states, confirm the thesis that the EMU is lacking common fiscal (budget) underpinnings. The EFSF tries, *inter alia,* to relieve the ECB of an immense burden that has been bestowed on it as it operates as a "fireman", much beyond its traditional mandate of preserving price stability. It appears, however, that the EFSF, be it with substantially bolstered resources and a broader range of operations (including bank recapitalization and sovereign debt purchases in secondary markets) would be an imperfect substitute to a solid budget arrangement. Anyhow, EFSF needs to beef up its firepower in order to deal with a crisis that is infecting Italy and Spain.

Unfortunately, there is a major cognitive dissonance on fiscal (budget) integration among euro zone leaders. One approach, which is embraced by Germany, the Netherlands, Finland, etc., sees euro bonds as a culmination of a gradual process of integration, apart from political and legal impediments; the other approach sees euro bonds as an effective method to combat speculative attacks, and as a major step toward creating a solid fiscal complement to the common monetary policy.[12] The fact that there are such conflicting views on this subject, the lack of capacity

11 See also Merler and Pisani-Ferry 2012.

12 A proposal made by the German Council of Economic Advisors indicates a shift in this direction (Bofinger et al. 2011). This proposal is in the vein of the ideas suggested by Depla – Weiszacker (2010).

to make decisions in due time (as has been happening constantly since the euro zone crisis started), the precarious intervention tools the EMU has at its disposal, make the aggregate deficits-based observation unconvincing. It may be that the deepening crisis would force a radical change of outlook and action, and trigger a speedy pace of fiscal integration in the euro zone. If not, it is hard to see how the euro zone will survive in its current outline. Asking governments to deflate once and again for the sake of closing down productivity gaps and reducing overall indebtedness is arguably not sustainable. Structural reforms may look nice on paper, but actual results may be too time consuming and uncertain and, thereby, further damage the cohesiveness of the EMU. The attempts of various governments to reinstate the gold standard during the inter-war period in the past century give plenty of food for thought on this matter. And, by the way, at that time governments could still use their own national monetary policy instruments.

Fiscal rules are needed in the euro zone, as sanctions are not working. But fiscal rules are far from being sufficient; they cannot be a substitute for a solid fiscal arrangement. Appointing a finance czar for the euro zone, who would make judgments and recommend penalties, is not enough either. There are EMU countries (Ireland, Spain) that had pretty cautious budget policies and relatively low public debts before this crisis. And everything was blown out because of excessive borrowing on the part of the private sector, which invited a boom and bust cycle. The euro zone needs a rounded up common policy in order to survive. This policy would have to respond to asymmetric shocks, as it is done in the US and Canada via the federal budget, where unemployment insurance is provided; it would also have to deal with deep financial integration via a common regulation and supervision of financial entities, as well as joint resolution mechanisms. For all this to operate there is need for fiscal integration, a common treasury. Even if Greece, and maybe a few other countries, were to exit the euro zone in an orderly fashion and without entailing major contagion, the EMU would, arguably, still need fiscal integration.

3. THE EU POLICY RESPONSE: CRISIS MANAGEMENT AND REFORMING THE EU (EMU) GOVERNANCE

The EU policy response to the financial and economic crisis has two components. First, there is a crisis management undertaking, which has tried to mitigate the economic downturn and avert a financial meltdown. The ECB has been compelled to take an active role in this, which has gone far beyond its original mandate. This exercise is impaired, however, by conflicting views regarding the root causes of the euro zone crisis. The inexistence of an effective *lender of last resort* (since the ECB is constrained in its operations and the EFSF is quite weak) has magnified a confidence crisis that has engulfed the euro zone. Second, there are measures aimed at reforming the EU's economic governance. This component is multi-faceted and has several aims, namely:

– Containing imbalances, in general, and fiscal consolidation in particular (by addressing the sustainability of pensions, health care and social benefits together with the adoption of national fiscal rules).
– Growth-enhancing structural reforms through higher employment and competitiveness.
– The reform of the regulation and supervision of financial markets and restore the health to the financial sector.
– The setting up of a permanent lending facility in the euro area (the European Stability Mechanism [ESM]).

The reform proposals package was adopted by the European Parliament in late 2011. The first three directions mentioned above form the gist of the Euro Pact Plus (EPP),[13] which was agreed upon by the euro area heads of state jointly with several non-member states. The Treaty on Stability, Coordination and Governance,[14] which was signed in March 2012, reconfirmed the EPP.[15] Under the EPP proposals, each individual country would be responsible for the specific action it would choose to implement in achieving the commonly agreed objectives, monitored through a set of economic indicators. From a normative point of view, the proposed measures could be seen as a step forward in improving the functioning of the euro currency area. Still, big challenges remain. These relate to the implementation, coordination and enforcement of these measures, as well as to filling in the gaps of the existing agreement. The agreement to create the EFSF and the European Stability Mechanism (ESM) answer a necessity, but is insufficient.[16] And the EFSF has proved to be quite ineffective as a crisis management tool, as a means of preventing contagion.

[13] The EPP is viewed by many as reflecting, basically, a Berlin view, but it also relies on proposals made by the European Commission and the task force headed by the President of the European Council, Herman van Rompuy.

[14] Some call it the Fiscal Pact.

[15] The Czech Republic and the United Kingdom decided to stay out of the Treaty.

[16] There are several issues to be noted about the EFSF and the ESM. First, there is the issue of the individual member contribution to the capital structure. Countries with lower credit ratings will end up paying up more to the ESM capital. Second, questions are raised over the perceived limited lending capacity of both EFSF and ESM. Third, the mechanism by which a loan guarantee is triggered in ESM places sudden pressures on domestic budgets in Member Countries.

The view that the proposed sovereign debt default mechanism will make the EMU, as it is now, not less prone to crises has been validated by events.[17] A related problem is that the ESM could bring about another inconsistency, namely the possibility of default, persistent imbalances and lack of proper fiscal arrangements (Munchau 2010). This brings us back to square one, namely, the possibility of having a monetary union without solid fiscal (budget) underpinnings. Added to this is how to foster real economic convergence in the EMU.

3.1. Containing imbalances

The EU's sovereign debt crises have heightened concerns for fiscal sustainability. Governments' responses during this financial crisis show once again that avoiding a systemic collapse necessarily entails burdening public debt (by taking over private debt). Thus, the policy of strengthened fiscal discipline should be seen in conjunction with policies addressing macroeconomic imbalances in the EU – an Excessive Imbalance Procedure (EPI) is considered, which is analogous to the Excessive Deficit Procedure (EDP).

A stronger SGP will be strengthened by improved surveillance and better data quality gathered from EU member states. The new system would rely on a much stronger compliance regime via "financial and reputational sanctions". The introduction of fiscal rules, as set out in the SGP, in national legislation is expected to enforce compliance with the SGP rules – which have been so often broken in the past.

The preventive arm of the SGP considers the sustainability of overall public debt, while the corrective arm targets a budget deficit path, which should bring down the debt to GDP ratio over time, in a consistent manner. The preventive component of SGP will limit public spending growth below the medium-term GDP growth until the target is met. It will also require that "best practice" budgetary procedures are implemented i.e. the adoption of multi-year budget planning, overview of fiscal targets by independent fiscal councils, the implementation of fiscal rules and increased transparency in statistics. These are useful innovations, which are likely to strengthen the preventive arm of the SGP.

However, there are changes to the corrective arm of the SGP, which would prove to be more challenging to implement in practice. The modification of the corrective component of SGP envisages the introduction of a 60% of GDP target for public debt, in addition to the 3% of GDP deficit limit. And if public debt ex-

[17] Since it will introduce speculative dynamics into it, and an analogy is made with the Exchange Rate Mechanism (ERM) that preceded the start of the euro zone (de Grauwe 2010b).

ceeded 60% of GDP, the country would be forced to bring it down at a pace of one twentieth of the excess over the previous three years.[18] These changes could raise several problems in practice. Requiring a country to bring down its public debt during recession may be self-defeating, owing to the pro-cyclical nature of debt to GDP ratios. Since debt ratios are above 60% of GDP in most EU countries, collective action in reducing public debt could have a negative impact on the whole EU economic growth; the risk of almost all EU countries acting in the same manner, i.e. enforcing the Maastricht criteria on public debt and deficit, could have a powerful recessionary bias in Europe. This should be seen in conjunction with the wide-ranging deleveraging under way (or what Koo (2011) calls a "balance sheet recession"), which is a bad omen for growth prospects. Meeting the objectives of the revised SGP in the absence of a workable framework for bank debt resolution and recapitalization could be challenging for all EU members. Both targets could be easily overshot under circumstances when some private institutions that are deemed too big to fail would need to be bailed out by national governments. Countries with high debt/GDP ratio could face credibility problems in meeting the targets at the required speed, as their policies would face serious economic and social constraints. This could impact their borrowing costs for a long time, hampering their fiscal adjustment program.

The EPP and the Fiscal Treaty seem to place a disproportionate weight on fiscal adjustment issues. Fiscal indiscipline was not a cause of the crises in Ireland or Spain, for instance. Private sector borrowing underlies large external imbalances inside the euro zone, as well as precarious bank balance sheets. As a matter fact, intra-euro zone current account imbalances have turned out to be so threatening because of the incompleteness of the EMU, of a lack of trust in its adjustment mechanisms. The debate in Germany, the concerns expressed by the Bundesbank about imbalances in the euro zone's central payment system, called Target 2, is quite instructive in this respect (Sinn 2012). In a genuine economic and monetary union such imbalances should be of pure statistical interest. This is what prompts some to consider that the way the EMU does function has a greater semblance to a "loose" single currency area, than to an actual monetary union (Munchau 2012). Likewise, low inflation and low levels of public debt are not enough to judge economic stability. And low structural budget deficits may not signal an incoming disaster. Spain illustrates this situation quite well because its structural budget defi-

18 A breach of either the deficit or the debt limits would trigger an infringement procedure and a fine of 0.2% of GDP if the country fails to comply. Rejecting a penalty proposed by the Commission would need a qualified majority in the Council of Ministers, i.e. by "reversal voting". "Excessive imbalances" of other economic indicators trigger a 0.1% of GDP penalty.

cit hovered around 1% of GDP in the pre-crisis years (the IMF even measured a structural surplus for Spain in 2007).

In view of this complex picture, the European Commission has come up with a scoreboard of macroeconomic indicators (as part of the *Six pack*) that examine internal and external imbalances, private and public indebtedness, banks' leverage and, not least, the evolution of unit labour costs. But one gets the feeling that this monitoring and making of policy recommendations would be extremely strenuous and fraught with much uncertainty. There will be ample room for bickering among governments in questioning the suitability of pieces of analyses, the measurement of structural deficits and policy recommendations on adjustment paths. And the EC's penalty system might not be credible as some of the indicators monitored are not policy variables and thus cannot be controlled by government policy (Manasse 2010).

Balanced budget over the cycle is a basic rule in order to make a monetary union function properly. This is the lesson one draws from federal states in Europe and elsewhere. However, the overhaul of the EMU's design and rules must go beyond the enforcement of budget discipline and the operation of *the golden rule;* this reform has to give member states scope for adjustment (of imbalances) at both national and supranational levels. It is commendable that the ECB has filled in the lender of last resort role, be it in a *sui generis* way – because of its mandate constraints and moral hazard. There is need for tools, at the euro zone level, which should consider highly diverse conditions among the member countries. There is convincing evidence that doubts the adequacy of national automatic stabilizers as a means to tackle asymmetric shocks. The Fiscal Treaty mentions 3% limits for effective budget deficits, but for some countries these may be pretty constraining in enabling an adequate counter-cyclical action against adverse shocks. An EMU scheme in this field, such as unemployment insurance, would be a sensible option.

3.2. Structural reforms

The reform proposals target two main areas where improvements could be made: labour market and competitiveness. It has to be noted that the same areas were singled out in need of enhancement in the Lisbon Agenda of more than a decade ago. However, progress in achieving those objectives was only marginal at best in most of the EU economies. The new proposals aim at remedying this. In practice, however, they could raise more problems and lead to growing discrepancies among EU economies.

Increasing competitiveness

The Six-pack proposals suggest assessing wage and productivity developments by looking at relative unit labour costs (ULC) in euro area countries and their trading partners. Imbalances between costs and productivity are supposed to be resolved through wage control growth, product market liberalization, improvement in R&D, infrastructure and innovation as well as the business environment.

But there are problems with these proposals. First, the one-size-fits-all logic applied across EU countries could have unintended consequences. Witness the effects that a single monetary policy had on EU peripheral economies during the boom years. Then, economies such as Spain or Ireland would have needed higher interest rates in order to prevent domestic macroeconomic imbalances building up. The same reasoning applies to the stated objectives of EPP on competitiveness. Initial conditions do matter and an attempt to somehow harmonise ULC[19] across EU member states using current indicators as benchmarks have the potential to lead to more destabilizing conditions in the future. Besides, economic growth is likely to slow further following the introduction of these measures, at a time when growth pick up is paramount for the success of country stabilization programs.

Second, competitiveness is not a policy instrument, and it cannot be influenced unambiguously and directly by governments. The authorities could strive to create premises for an economy to develop, but the ultimate outcome is a complex result of a market given context. New Member States (NMSs), for instance, have traditionally benefited from lower labour costs, but other factors such as inappropriate physical and skilled human capital in various sectors, or a low level of R&D impact adversely on their long-term competitiveness. Moreover, building up higher stocks of capital takes time and implies fast economic growth rates. For most NMSs a major policy issue is how to enhance resource allocation toward tradable sectors. For this crisis has revealed flaws of the pre-crisis growth model.

Not least, the focus on ULC as a measure of a country's competitiveness might be seriously misleading. Felipe and Kumar (2011) suggest that there are conceptual problems with it. If ULC is considered, then unit capital cost (UCC), that is the ratio of profits to capital productivity, would also have to be looked at. The authors demonstrate that capital productivity has been displaying a declining trend in the EU. Moreover, a ULC for tradable goods comparison across EU countries could be misleading because of the complexities of export products, which vary across the EU

19 There are various measures of competitiveness indicators, which often yield different results. Although proposals by the EPP suggest a range of ULC indicators to be used for various sectors of the economy, these still remain just one measure of competitiveness – most likely chosen because they facilitate comparisons across EU countries on a similar basis.

economies. NMSs tend to export lower value added and lower technology products, while Germany, for example, exports over 12% of the world's top 10 most complex products. Thus, if Germany were supposed to provide a benchmark for competitive policies in the EU, based on ULC, it would in fact distort the whole picture and impose unfounded constraints on other countries' policies.

There would also be major implications for national policies, which are requested to undertake corrective measures. Governments could become more involved in the management of the economy, in mediating between social partners for the sake of achieving competitiveness targets. And as competitive devaluation can be damaging overall, the same could happen with "competitive" wage controls throughout the EU.

Fostering employment

Each national state would have to implement policies aimed at increasing participation rate, lowering labour tax rates or increasing lifelong learning. While from a normative point of view such policies are desirable, their pursuance might yield the expected outcome in the long term only. The labour market is far from being flexible across EU countries. Apart from labour market restrictions – which still apply to some NMSs such as Romania or Bulgaria, five years after they joined the EU – labour mobility within the EU remains low compared to the US. Citizens of NMSs face relatively high migration costs given their earning power. A uniform labour market reform across EU economies could have asymmetric effects as labour, being mobile, could shift towards most developed economies where wages are much higher. The richer EU countries are also devising means to attract highly skilled labour from poorer countries.

3.3. Financial sector's regulation and supervision reform

European policy-makers are advancing with an overhaul of the regulatory and supervisory structures of financial systems, including the parallel (shadow) banking sector and rating agencies. Harmonization of rules is not a sufficient response to the crisis, since the very content of regulations and supervision needs radical change.[20] A reformed regulatory and supervisory framework would observe basic

[20] This is what comes out prominently from the de Larosiere et al. Report (2009) and the Turner Report (2009) (in the UK), from documents of the European Parliament and directives of the European Commission, the Monti Report (2010), etc.

principles such as regulation of all financial entities (including hedge funds and private equity funds), higher capital and liquidity adequacy ratios, capping leverage, limiting bonuses, bringing derivatives into the open and having their trading regulated, preventing regulatory arbitrage, transparent accounting rules, and addressing systemic risk. There is need to strengthen the regulation and supervision of major financial groups, which operate cross-border. Together with the new supervisory authorities, the European Systemic Risk Board (ESRB) should bring a decisive plus in this regard and develop macro-prudential regulation.

In September 2011, Britain's Independent Banking Commission released its report, which suggested that the financial system would be more resilient to future crises if banks' retail were ring-fenced as against investment units. But this report comes short of the proposal put forward by Paul Volker, the former Federal Reserve Chairman, who suggested a complete separation between the two bank activities, as they were prior to the abrogation of the Glass-Steagall Act of 1933. As a matter of fact, the "too big to fail" issue is still unaddressed by policy-makers and, ironically, the unfolding of the financial crisis has resulted in bank consolidation, which entails a heightened moral hazard problem (Johnson – Kwak 2010).[21] Global competition and the fear of regulatory arbitrage are not peremptory arguments in this respect. The persistence of this problem rather reflects the power of vested interests.

Consistent public sector bailouts of the private sector, notably of the banking sector, continues to pose more questions than solutions. The cross border structure of European bank operations and the years of resource misallocation have left many banks in Germany, France and Austria with a heavy exposure to peripheral EU countries and NMSs, i.e. those countries which now undergo painful adjustment programs. There is a vicious circle emerging, in which the refinancing of debt from countries with lower credit ratings is being done indirectly by those euro area member countries which have a solid interest in protecting the health of their national commercial banks' balance sheets. But the onus of adjustment is almost entirely put on the taxpayers of the countries in distress, which raises a host of practical and moral issues. A legitimate question therefore arises: is such an arrangement appropriate and sustainable (does it take into account the need for burden-sharing?[22]).

21 As put by Goldstein and Veron (2011), this issue is more challenging in Europe owing to a higher concentration of banking markets than in the US, general reluctance to let banks fail, the interdependence between banking and political systems and, not least, nationalism.

22 Burden sharing can be seen through two pairs of lenses. One regards whether private investors (bond-holders) share the costs of debt restructuring. The other one refers to the distribution of costs among EU member countries. Hence the political sensitivity of this issue. Both perspectives imply the impact of an eventual sovereign debt restructuring on banks' balance sheets.

The EU should acknowledge an insolvency problem and come up with some form of debt restructuring for distressed sovereigns whose public debt is on an unsustainable path;[23] this would imply a restructuring or even closing down insolvent European banks.[24] This option would also go some way in addressing the so-called "burden sharing" issue among EU countries, since it was the banks from creditor EU members which provided loans that subsequently turned bad in the first place.[25] Clearly, such an action asks for a political decision in the EU donor countries, in Germany in particular.[26]

The massive haircut applied to Greek sovereign debt was a breakthrough in this regard and forces banks to build up their capital, but it also creates a precedent in terms of capacity to contain contagion. For sovereign debt restructuring,[27] however orderly it can be, may not prevent contagion, which would have its cost open-ended. This is, arguably, what the ECB fears mostly in a rushing of things. But putting off the day of reckoning may not be less costly.

The crux of the matter seems to be how to make private investors accept haircuts while reopening financial markets to the countries in financial distress by making their adjustment programs as credible as possible. This is a catch-22 dilemma. Coping with this dilemma brings the issue of fundamental repair of the EMU design to the fore.

3.4. Dealing with global imbalances

The current crisis has reinforced one of Keynes' intellectual legacies, which was enshrined in the Bretton Woods arrangements – namely, that highly volatile capi-

23 The prevailing common view in various EU institutions, including the ECB, is that a country which commits itself to a credible adjustment program cannot be considered insolvent and thus should not be placed in a position to restructure its debt. What the ECB has seemed to fear mostly is contagion brought about by a sovereign debt restructuring, even if performed in an orderly manner.

24 Until recently, stress tests performed across European banks have failed to incorporate extreme scenarios, such as default by a member state, simply because such a default is perceived to be politically inconceivable and would trigger powerful contagion effects (Darvas – Pisani-Ferry – Sapir 2011).

25 The possibility of the adoption of collective action clauses (implying *haircuts*) by euro area members, involving agreements between debtors and creditors over debt restructuring, has been explored at the European level (BiniSmaghi 2010).

26 For the political and social climate, which goes against such a solution, see also Guerot – Leonard (2011). The spectacular political advance of the "True Finns Party" in Finland speaks volumes about the contradiction between economic logic and political reality.

27 Debt restructuring distinguishes between reprofiling of bonds, with their maturity extended, and write-downs (haircuts) on the value of the debt. The latter would impact significantly on quite a few banks' balance sheets, which would need recapitalization.

tal flows are inimical to trade and growth, and that financial markets are inherently unstable. As a matter of fact restraining financial flows is a way to solve the impossible trinity, which says that an autonomous monetary policy, stable exchange rate and free capital flows cannot be achieved concomitantly.[28] The increasing number of emerging economies which resort to capital controls (in order to stem speculative flows) is quite telling about actual dynamics in the world economy. The IMF's policy turnaround in this respect is also noteworthy.

4. THE POLICY SPACE CHALLENGE

Being devoid of autonomous monetary and exchange rate policies, economies in the Euro zone have a pretty narrow adjustment policy space; this leeway is more constraining the less capable they are of registering appropriate productivity gains. When diversity and competitiveness gaps are large, policies can easily bring about bad equilibria, which can have nasty social consequences. Political leaders realize that there is a big threat here, that something has to be done in order to mitigate social costs and cope with rising unemployment (in Spain and Greece unemployment has reached about 20%, and among the youth it grew to a mind-boggling 50% by the end of 2011). The summit of March 2012, where the Fiscal Treaty was signed, emphasized the need to find ways to stimulate growth and create jobs. One should bear in mind that social cohesion can be lastingly impaired by years of austerity and vanishing hopes of better times. And without social cohesion, democratic politics can fall victim. But this wakeup call is not enough, for the diagnosis of the euro zone crisis has to be rounded up.

Structural reforms have been initiated in Italy and Spain by the governments headed by Mario Monti and Mariano Rajoy, respectively. But these reforms take quite a while to come to fruition, and time is of the essence in order to stem vicious circles taking root, not to mention the pressure coming from structure. Therefore, Union level policies are necessary in order to mitigate the pains of economies which are mired in major austerity programs. Forcing some governments to bring deficits down very quickly can be self-defeating; fiscal consolidation has to be tailored to specific circumstances. Where there is fiscal space, it should be used to boost aggregate demand at the euro zone level. A speedier disbursement of EU funds for good investment projects would also help. And what the ECB can do in terms of discouraging speculative attacks and bring bond yields down can make a hell of a difference. The Italian Prime Minister Mario Monti and others are quite right in this regard.

28 This is shown, analytically, by the Mundell-Fleming model.

There is a train of thought worrying that although enhancing policy space does make sense during a period of structural reforms, it may dent the determination to pursue them (Kirkegaard 2012). This argument should not be overlooked. However, one never knows if a a country put under a lot of pressure crosses a dangerous line, when it can cause a social breakdown and political disarray. This is why EMU level policies are needed, as an offset element to painful internal adjustment programs.

The way the euro zone is constructed now and what comes out of the Fiscal Treaty and other governance reform measures make one think that in spite of the operation of national automatic stabilizers and the transfer of some funds via the EU budget, the EMU is functionally more rigid than the gold standard regime of the inter-war period, during the last century. That regime was named, quite suggestively, the "golden fetters" by Eichengreen (1992). What happened during those years, not least because of inadequate economic policies and post-war arrangements (including the reparations imposed on Germany), is quite ominous.

There is also the issue of growing uncertainty and proliferation of extreme events ("black swans", as Taleb calls them).[29] Demographic pressures, too, have to be factored in, for aging is putting additional pressure on welfare programs. The European social model is in trouble since long and its thorough reform is badly needed (which does not imply that it has to be dismantled). Consequently, more "fiscal space" would better be available in the years to come. This should urge governments to be cautious about budget (expenditure) policies even in years of economic growth. This said, however, too rigid rules and an uneven distribution of tasks among adjustment instruments, in view of their effectiveness at national and supranational levels, can harm policy-making; it would lead to sub-optimal outcomes, to a deflationary bias throughout the Union.

Developing the *Single Market* has merits in helping resource allocation and making markets more flexible; this was the gist of the Monti Report which was made public by the European Commission in 2010. But market rigidities cannot be done away with by decree; they are embedded in social, cultural and regional contexts. And in an increasingly large and diverse Union, making national milieus more compatible among themselves is time consuming. What national policies cannot do, because of constraints imposed by joint rules and structural features of national economies, should be compensated by instruments at the supranational level. A budget of the EMU, funded by joint bonds, seems to be inescapable in the end, although it clashes with prevailing views in some countries.[30] And raising the firepower of the ESM would work in the same direction.

[29] For the importance of random events in our life see, among others, Mandelbrot (2004) and Taleb (2008).

[30] For Germany, see the insightful analysis made by Dullien – Guerot (2012).

Disentangling private from public debt has become an overwhelming issue in the EU in view of its deep financial integration. Private sector (bank) debts are making up enormous contingent liabilities on public debts when bankruptcies are not tolerated (not to mention the moral hazard problem). This is one of the revelations entailed by the current crisis. And the inability to disentangle the myriad of intertwined debts will impact, negatively, on fiscal policies for years to come. Even now, this feature of deep financial integration seems to be under-estimated by some. What is worrisome is that bank consolidation would preserve the hostage relationship governmental budgets are held in. Ways must be found to make sure that a golden rule of market economy operates, namely, that investors bear the risks they assume and losses are not socialized.

Fiscal rules, surveillance and peer pressure are not enough for strengthening the cohesion of the EMU, of the EU in general. A handicap in the EU is linked to the political reality that taxpayers are, ultimately, national citizens. Can "common goods" (including the euro) be protected unless "common resources" (the EU budget?) are more substantial? Can resolution schemes and orderly restructuring schemes of sovereign debts be devised so that they compensate the smallness of the EU budget and complexity of the EU decision making process? Can the EU policy-makers use additional instruments in order to foster more real convergence in the EMU, in the EU as a whole? Is there room for strengthening policies at EU level?

Were this crisis come to an end, would a deflationary bias in the conduct of monetary policy appear in view of the willingness to prick bubbles in their infancy? On the other hand, would it not, by fostering less instability, support long-term growth? In a way, answering this question is analogous to deciding on the proper speed of implementing Basel III: for a too fast implementation could stifle recovery; while a too slow implementation would create prerequisites for a new crisis.

Does size matter in judging fiscal risk? It appears it does. Large economies are, seemingly, considered to have a bigger capacity to resist shocks; they are, potentially, more resilient. Resilience (ability to withstand external and internal shocks) will increasingly be a principal policy aim in the years to come.

What would be the impact of new technology for circumventing rules (e.g. high-frequency trading)? Regulators and supervisors need to take this into account as well, when thinking about financial stability. The latter can be linked also to the capacity of an economy to withstand the effects of natural disasters, with social strain. Demographics, too, play in a role when it perturbs inter-generational balance and, consequently, fiscal equilibria.

The years to come will quite likely be accompanied by an increasingly uncertain environment; complexity will also be on the rise. These circumstances advocate a more simple, resilient financial intermediation system, for the sake of its own stability. If this does not happen and global imbalances persist, more fragmentation is to be expected, with societies probably turning more inward looking. This will have profound implications for the global system. It may be that in view of the lessons of financial crises and of the need to lend to economies more resilience, there is an optimal size of openness (trade and finance-wise). This implies that firms need to think globally and operate selectively as a means of mitigating risks.[31] It may also be the case that we will end up with a three blocs-based financial system as a means to maintain a relatively open global system.

"Japanization" of EU economies is a distinct possibility in view of the legacy of this terrible crisis and power redistribution in the global economy. One should also bear in mind the erosion of the middle class that has been taking place during the last couple of decades in the US and in numerous European countries; this process complicates adjustment and reforms, in general.

SUMMING UP

Structure and networks are crucial to understanding the roots of the current crisis. Such a perspective reinforces the rationale for a reform of the EU economic governance and a radical overhaul of the EMU institutional and policy arrangements. As this crisis indicates, it is not only fiscal rules and their compliance with that a proper functioning of the EMU hinges on. Flaws of financial intermediation, growing imbalances stemming from the dynamics of private sector saving and investment flows, inadequate regulation and supervision of financial markets, and, not least, inadequate budget arrangements (the lack of a common treasury and missing instruments in combating asymmetric shocks) have played a major role in triggering the sovereign debt crisis in the EMU. The overexpansion of financial institutions and their investment behaviour are to be highlighted as well. Consequently, a reform of the EU economic governance has to deal with fiscal rules and compliance, macroeconomic disequilibria and competitiveness gaps, the regulation and supervision of financial markets; the design of the EMU needs to be thoroughly remade. In the meantime, firm crisis management has to be used in order to prevent a breakdown of the euro zone. The need to tackle global imbalances and overhaul international arrangements is to be mentioned in this context.

Fostering real economic convergence remains a huge challenge. A threat for the EMU is a growing cleavage between its northern tier and its southern tier, with

[31] Other catastrophic events (like the Fukushima disaster) highlight the risks of over-dependency on various sources of supply.

the latter possibly becoming mired in vicious circles, incapable of overcoming the impact of fiscal consolidation in a hostile external environment.[32] Another chasm could deepen between older EU member states and some NMSs. Can the Europe 2020 strategy provide a light in this regard? NMSs have a deep stake in EU governance reform since they cannot escape the impact of EU wide externalities and the functioning of their economies depends on the rules of the Union.

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