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Strengthening Economic Governance in Europe

A Joint Chatham House, Elcano and AREL Report

Stephen Pickford, Federico Steinberg and Miguel Otero-Iglesias

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S. P.
F. S.
M. O.-I.

Abbreviations and Acronyms

AQR	Asset Quality Review
CDOs	Collateralized debt obligations
EBA	European Banking Authority
ECB	European Central Bank
EcoFin	Economic and Financial (Council)
EDP	Excessive Deficit Procedure
EFSF	European Financial Stability Facility
EIOPA	European Insurance and Occupational Pensions Authority
EIP	Excessive Imbalances Procedure
EMU	Economic and Monetary Union
ESA	European Supervisory Authorities
ESM	European Stability Mechanism
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
FSA	Financial Services Authority
IMF	International Monetary Fund
LOLR	Lender of last resort
LTROs	Long-term Refinancing Operations
MIP	Macroeconomic Imbalances Procedure
MTOs	Medium-term deficit objectives
PSI	Private-sector involvement
OCAs	Optimal currency areas
OMT	Outright monetary transactions
QMV	Qualified majority voting
SDS	Single deposit insurance scheme
SGP	Stability and Growth Pact
SMP	Securities Markets Programme
SRM	Single Resolution Mechanism
SSM	Single Supervisory Mechanism
TARGET2	Trans-European Automated Real-time Gross settlement Express Transfer system
TARP	Troubled Asset Relief Program

Executive Summary and Recommendations

The euro was launched 15 years ago through the Maastricht Treaty, and was expected to make Europe stronger economically and more integrated. Although the Delors report in 1989 correctly identified many of the structures needed to make EMU work, the Maastricht design underplayed the importance of labour and product flexibility, and of divergences in competitiveness. For most of its first decade the euro area grew quickly, coinciding with a period of very rapid world growth.

However, the global economic and financial crisis that started in 2007 hit Europe hard, exposing serious flaws in its original design. Although the crisis began in the United States, Europe ended up being the worst-affected region. At one point, markets and commentators began to ask serious questions about whether the single currency could survive.

Important measures were taken to save the euro, and since 2012 markets have become calmer, as European leaders and policy-makers signalled they were prepared to take tough decisions. In particular, the president of the European Central Bank (ECB), Mario Draghi, promised to do 'whatever it takes' to protect the euro.

This report examines why the economic and monetary union (EMU) was so badly affected by the crisis, and assesses whether further changes need to be made to the structure of economic governance that underpins it.

Key findings

As the crisis unfolded, the problems facing the euro area were initially misdiagnosed. In the first phase, the crisis was thought to be largely a US, or Anglo-Saxon, problem; and the policy response was predominantly by individual member states, with limited coordination across Europe. In the second phase, as the situation in Greece became critical and as further sovereign debt issues emerged, the main problem was perceived by Europe to be fiscal profligacy in the 'south', and the primary response was to tighten fiscal policies. Not until the third phase, when countries faced much higher costs of borrowing and the full extent of the vicious circle between sovereign and banking debt problems became apparent, did the euro area finally start to tackle comprehensively its underlying financial-sector problems. It also came to understand that only the ECB had the necessary tools to deal with the crisis, and that these needed to be accompanied by commitments to further integration and structural reforms in the euro area.

Only in the more recent phases did the policy focus shift from crisis management to longer-term reforms. But the process of reform has been laboured and slow, with difficult political decisions often being taken only when the situation became critical. Its sequencing has also been complex, with the ECB making clear that measures to deal with the crisis were dependent on political agreement to further reforms to bring about greater integration in the euro area.

The crisis exposed serious shortcomings in the design of EMU. The euro area falls well short of the requirements for an optimal currency area. In particular, its members have not converged sufficiently; indeed, during the 'Great Moderation' divergences in competitiveness between euro area countries increased substantially. Also, euro area economies are not flexible enough. Furthermore, EMU does not have mechanisms to allow transfers from the stronger to the weaker economies. Nor does it place sufficient responsibility on surplus countries to make adjustments to deal with imbalances.

The experience of the euro shows that political considerations are also important. There needs to be deep fiscal integration within the currency area, a lender of last resort for sovereigns and banks, and an effective mechanism to break the link between banks and sovereigns (the 'doom loop'). Euro area countries learnt the hard way that joining EMU meant that they were issuing debt in a currency that they did not control.

Without exchange rate flexibility or sufficient factor flexibility, the internal devaluation needed to adjust to falling competitiveness produced a deep recession and persistently high unemployment in countries with external deficits. The euro area experience also shows that countries joining the currency union have insufficient incentives to implement the structural reforms needed to make their economies more flexible and more convergent.

Much of the initial reform energy has been concentrated on strengthening fiscal discipline on euro area members; but countries still have incentives to circumvent the tighter rules, and little has been done to integrate fiscal policy more closely across the euro area. There is still a widespread view in Europe that the main problems lie with countries' unwillingness or inability to implement the rules properly. But experience shows that strict adherence to the fiscal rules is not enough.

There have also been substantial reforms in the financial sector, but important obstacles remain. New policies have been put in place or proposed, and new institutions created at the European level, to strengthen financial regulation and supervision, resolve failing institutions, guarantee deposits and introduce macro-prudential policies. But to complete these reforms, agreement is needed on a common fiscal backstop, and on how to divide the costs of resolving failing banks and protecting depositors; the many bodies responsible for different aspects of financial policy need to coordinate better; and a proper lender of last resort for the euro area is required.

Structural reforms and macroeconomic coordination have also been started, but there is an underlying tension between national and European interests. Structural reforms are essential to make EMU function more effectively, but most of the responsibility for designing and implementing these reforms lies with individual countries. Given the interconnections across the euro area, structural reforms should be better coordinated. The current lack of macroeconomic coordination between member states, and across the European institutions, also needs to be addressed.

Taken together, the governance reforms are moving in the right direction, but they do not go far enough to make EMU work effectively. Without deeper fiscal and economic integration, and the institutions to deliver it, the monetary union will remain unstable and vulnerable to further shocks. And to deliver this deeper integration, some degree of greater political union will be required.

In the absence of sufficient economic convergence, fiscal transfers are indispensable to offset asymmetric shocks. But there also needs to be a deeper fiscal union with strong and credible surveillance over countries' budgets in order to avoid moral hazard, union-wide taxes to raise revenues, and centralized debt instruments to fund a common budget and ensure debt sustainability.

The monetary union also needs a sovereign lender of last resort, and a banking union with a common fiscal backstop to avoid financial fragmentation and break the link between banking and sovereign debt. The lack of an effective mechanism to break this link exacerbated the divergence in economic performance between the core and the periphery of the euro area.

So, **within the euro area, fiscal policies have to be more coordinated, financial systems more integrated, and structural economic policies more convergent.** Also, there needs to be more effective coordination between these policies, which are the responsibility of different institutions with varying powers and accountabilities. And this has to be backed up by adequate political institutions and governance structures capable of responding in times of crisis.

Political constraints

These reforms will not be easy. The experience to date is that European decision-makers find it very difficult to agree reforms unless faced with a crisis.

Moving towards fiscal, banking and economic union also entails a substantial transfer of sovereignty. This raises big questions about democratic legitimacy and accountability. There is a risk that decisions will be increasingly made at a level that most European citizens perceive as too remote. This can probably only be addressed by moving towards some form of greater political union involving enhanced powers for the Commission and European Parliament – and this poses yet greater obstacles, since it requires reforming the European Union treaties.

There are a number of important obstacles to changes which would tackle the democratic deficit. One difficulty is to manage Germany's increased power on economic (and political) matters. Another obstacle is that a number of other countries are reluctant to open up treaty reform again. Finally, many euro area politicians feel that until growth resumes and unemployment falls, there is no significant popular support for more integration at the European level.

It is feasible to achieve deeper integration on an inter-governmental basis, but it would result in a loss of sovereignty for 'debtor' countries. For example, giving more powers to the president of the Eurogroup while retaining final decision-making at the Council level would, in principle, not need a substantial treaty change. But it would give a greater veto power to smaller creditor countries.

Ultimately, deeper integration that preserves symmetry requires transferring more powers to European institutions, and this can only be achieved through treaty change.

Recommendations: key governance reforms

1. **The experience of the crisis shows that, in order for EMU to function effectively, there needs to be greater fiscal, financial and economic integration within the euro area to match the degree of monetary integration.**
2. **The euro area needs a single central fiscal authority with its own source of revenues, the ability to issue debt, and the capacity to make ongoing fiscal transfers within the euro area.** This authority (headed by the president of the Eurogroup – in effect the economic and finance minister for the euro area) should also be responsible for monitoring national fiscal positions, and enforcing the fiscal rules. It would in addition set the overall fiscal stance for the euro area as a whole, and debt issued centrally would be joint liabilities of all euro area members.
3. **There needs to be a single financial rule book, and a common mechanisms for supervising all euro area banks (both big and small), resolving failing institutions and guaranteeing deposits.** Some of these are currently being put in place. But there also needs to be further progress on putting in place a single resolution mechanism and a common deposit guarantee mechanism. Progress on these is being held up because of a failure to agree on how the costs would be divided.
4. **The single resolution mechanism needs to have a credible financing structure.** With bank liabilities in the euro area totalling over €30 trillion and given the possibility of large bank failures, both the resolution mechanism and the common deposit guarantee system need to have a clear fiscal backstop, ultimately provided by the central fiscal authority.
5. **Positive incentives need to be put in place for countries to undertake difficult structural reforms on an ongoing basis, so that their economies are flexible and innovative enough to live within a single monetary area.** The single fiscal authority could provide finance for country-specific reforms that are essential for the area as a whole. Contracts between countries and European institutions to provide financial resources for structural reforms could provide the right incentives.
6. **There need to be effective processes to coordinate monetary, fiscal, financial and structural policies – and the institutions responsible for them – across the euro area:**
   - a regular dialogue between the central fiscal authority and the ECB;
   - close coordination between the ECB and the ESRB (as well as the central fiscal authority) on macro-prudential policies; and
   - coordination by the Eurogroup of overall economic policies (both national and euro-area-wide), backed up by regular economic summits of euro area leaders.

7. **The ECB needs to be able to act as the unconditional lender of last resort for member states in exceptional circumstances,** as well as for euro area banks.
8. **These reforms will require new institutions, and changes to the mandates of existing institutions.** Reaching agreement on the creation of a central fiscal authority and changes to the ECB's mandate will be particularly challenging.
9. **The centralization of powers and resources that this greater level of integration involves will require a greater degree of political union, to provide democratic legitimacy and accountability.** These proposals imply a profound transfer of sovereignty from member states to European institutions, and go beyond what has been proposed so far.
10. **Treaty change is ultimately the only realistic path to greater legitimacy and a more symmetric union.** However, the last ratification process has left many countries reluctant to go down this path.

These changes are needed to make EMU work effectively, to realize its potential and to avoid future crises which could threaten its existence. But stronger integration and deeper union between the EA members will stand in stark contrast to the much more limited degree of coordination within the wider EU. This will provide non-members with a very difficult choice.

Some changes need to be made quickly in order to make EMU more resilient. Others will take more time, given the political constraints. But until they are implemented, the economic and monetary union will remain vulnerable to further crises that could threaten the stability of the euro.

By the end of this decade banking union should be largely complete. The single supervisory mechanism should be fully operational and the single resolution mechanism framework in place, with a sizeable resolution fund financed through banking-sector levies (although it will still need a substantial fiscal backstop).

Some further integration can proceed on an intergovernmental basis, such as extending the powers of the Eurogroup president. But this is a second-best way forward, and may not be politically sustainable.

To achieve the more radical – but necessary – reforms, a new treaty will be required. A major priority for this new treaty would be to create a single fiscal authority for the euro area and to change the ECB's mandate, so that it could become a full lender of last resort in extreme circumstances.

Finally, euro area citizens need to be given a real choice between continued fragmentation (which leaves the euro exposed to structural weaknesses and recurrent crises), and greater integration (which pools more sovereignty at the same time as it strengthens the governance of EMU).

1. Introduction

The euro was born 15 years ago. Hopes were high from the outset that it would make the economies of Europe more stable, more integrated, and more prosperous.

After some success in the early years of the single currency's existence, when the world economy was growing strongly, the global and economic financial crisis from 2007 onwards hit it hard, to the point where serious questions were asked about whether the euro could survive.

Action was taken in 2012, in particular by the European Central Bank (ECB), and its president Mario Draghi declared that it would do 'whatever it takes' to protect the euro.[1] As a result these questions about the sustainability of EMU have receded for the moment. But some of the major underlying issues remain. So now is a good time to take stock of how sustainable EMU currently is, and what further actions might need to be taken.

The initial impetus for EMU was provided by the Delors report in 1989.[2] This anticipated large economic benefits from the creation of a single currency. But beyond that, greater integration within Europe was also seen as desirable in its own right.

The original Delors committee design for the euro was initially based on the theory of optimal currency areas, which stressed the need for economic convergence and integration within the region. This theory also emphasized the importance of sufficient flexibility in economic structures, in particular in the labour and product markets, and mechanisms to allow adjustments to take place across the region in the event of insufficient convergence.

Now that we have 15 years' experience of how the single currency has worked in practice, in both good times and bad times, it seems clear that its structure needs to be improved further and its governance strengthened.

The crisis exposed major problems. But initially the problems were misdiagnosed. Many European leaders thought the problems were restricted to the United States, and caused by the overzealous application of Anglo-Saxon economic liberalism. Then, as countries started to run into deficit and debt problems, the prevailing view was that these countries themselves were mainly to blame for running too lax fiscal policies. At the same time, when European banks started to fail, the problems were seen as being caused by inadequate regulation and supervision. But initial efforts to coordinate a European response through stress tests of banks' balance sheets were seen as flawed, and mechanisms for resolving failing banks remained largely a national responsibility.

This report argues instead that the root cause of the problems lay not only with weak financial oversight or lax fiscal policies, but also and more fundamentally with the underlying design of EMU and its governance.

Although the Delors report correctly identified many of the structures that needed to be in place to make EMU work, the 1999 design implemented by the Maastricht Treaty fell short in a number of respects. In particular, the importance of labour and product flexibility and mobility was underplayed, and the significance of divergences in competitiveness between countries within the single currency area – and of the resulting balance-of-payments surpluses and deficits – was largely ignored.

Since the start of the crisis certain reforms have already been put in place, and these address some of the gaps. While policy-makers' initial emphasis had to be on managing the crisis, over time Europe has tried to tackle some of the underlying governance problems. However, these reforms are insufficient for EMU to work effectively and to correct the design flaws.

This report looks at the performance of EMU over its 15-year life, and draws lessons about its flaws. It then

1 Draghi (2012).
2 Delors (1989).

goes on to identify what elements are missing and what more needs to be done. It also looks at the obstacles, both economic and political, which will need to be overcome in order to put the necessary reforms in place.

Chapter 2 gives a chronology of the crisis, and sets out how a series of misdiagnoses affected the capacity of Europe to manage the crisis effectively. Chapter 3 then draws lessons from the experience of the past 15 years, in both good times and bad times, about how effective the design of EMU has been. Chapter 4 outlines the policy reforms that have already been introduced in response to the crisis, both to manage it and to undertake more substantive reform of the system, and assesses their effectiveness. Chapter 5 takes stock of where we are now and identifies what reforms are necessary for EMU to work more effectively, in terms of delivering banking union, fiscal union and economic union, and the issue of coordination across the policy areas. It also looks at the obstacles that will be faced in delivering these further reforms. Finally, Chapter 6 summarizes the findings and makes recommendations for further action.

The broad conclusion of this report is that substantially greater integration across all aspects of economic policy is required if EMU is to work effectively. In addition, political reforms will be needed to provide democratic legitimacy for more integrated and coordinated policy-making within the euro area. This is turn will have important implications for non-euro members.

2. The Unfolding Crisis in the Euro Area

In order to understand the problems that have emerged, this chapter identifies four distinct phases of the crisis since 2007, showing how the diagnoses of the nature of the crisis changed over time, and how they influenced the proposed policy solutions. Initial misdiagnoses not only diverted attention from the measures needed to fix the euro, but also considerably delayed a comprehensive response across the euro area.

The political response to the crisis began with uncoordinated, unilateral national actions, then moved to two phases of crisis management at the national and European levels, and finally shifted to a focus on longer-term structural reforms across the euro area. One key aspect which helped European policy-makers regain (at least temporarily) a certain degree of control over the situation was the realization that there were strong linkages between the necessary long-term political solutions requiring further integration and the crisis management policies available to the ECB. Stronger crisis response mechanisms were conditional on political agreement to changes in the structure of EMU.

In the early stages of the crisis, from 2007 until 2009, euro area policy-makers thought that it was predominantly an American crisis with its origins in the subprime market. They overlooked the underlying structural weaknesses of EMU, especially the problems of divergence between surplus and deficit countries, and how these exacerbated contagion between countries in the currency area.

In the second phase, in 2009 and 2010 when the Greek crisis emerged, the dominant diagnosis in the euro area creditor countries was that the problem was mainly due to fiscal profligacy in the 'southern' countries, and that the solution was a period of austerity. However, Greece faced its own special problems, and Ireland's and Spain's troubles were mainly concentrated in the banking sector. Slowly it became accepted that current-account imbalances within the euro area were as much of a problem as fiscal unsustainability.

By the end of 2011, in the third phase, key euro area policy-makers understood that the ECB was the only institution with the instruments available to protect Italy and Spain from financial contagion (since both countries were too big to fail but too big to be rescued). They also realized that the ECB's fire-fighting capacity and emergency support needed to be linked to commitments by euro area countries to implement further integration and structural reforms.

The last phase was the calmer period since Mario Draghi's 'whatever it takes' speech in July 2012 and the 'Four Presidents' report of December 2012.[3] This blueprint for moving towards banking, fiscal, economic and political union, and the Outright Monetary Transactions (OMT) programme of the ECB, has (at least for the time being) convinced markets about the political determination to make EMU work. The crisis in Cyprus in 2013, although badly managed, did not reignite market turmoil. However, progress towards a banking union is slow, and fiscal, economic and political union are still distant objectives, with the risk that the pace of reforms will slow down as the global crisis recedes.

Phase 1: a US-only crisis?

After years of sustained growth and rising real estate prices, in the summer of 2007 the US economy began to implode. The global financial crisis started in the US subprime mortgage market and developed quickly into a global credit crunch. The ECB reacted promptly and substantially as global liquidity began to dry up. On 9 August 2007

3 Van Rompuy (2012).

it injected €95bn ($130bn) into the European interbank market to bring down the lending rate which had spiked after BNP Paribas (the second biggest bank in the euro area) announced that it had frozen its funding to three hedge funds heavily exposed to the US subprime market.

In the coming months trust between financial institutions evaporated quickly and those that were over-leveraged faced huge problems in accessing the wholesale markets. The Federal Reserve, the ECB and the Bank of England coordinated their provision of liquidity to financial markets to ease the credit crunch, but this did not prevent banks starting to fail. The first institution to fall was the UK's Northern Rock, which in September 2007 succumbed to a bank run, and was effectively nationalized.

In a domino effect, the next months saw the collapse of some of the biggest investment banks in Wall Street, including Bear Stearns, Merrill Lynch and (in September 2008) Lehman Brothers. While the first two failures were resolved and the banks sold to JP Morgan Chase and Bank of America respectively, Hank Paulson, the then Secretary of the Treasury, decided that taxpayers' money would not be used for Lehmans (against the advice of his European counterparts, Alistair Darling and Christine Lagarde, who pointed to the possible shock waves that allowing it to go bankrupt could trigger[4]). The collapse of Lehmans did indeed lead to global panic, and only days later the US government had to bail out the global insurance company AIG and ask Congress for a $700bn Troubled Asset Relief Program (TARP) in order to prop up the country's entire banking sector.

By October 2008 the crisis had already reached the euro area. At the end of September, the governments of the Benelux countries and France bailed out Fortis and Dexia, and the German government did the same with Hypo Real Estate. All these institutions were heavily exposed through collateralized debt obligations (CDOs) to the US financial system, which added to the belief among euro area policy-makers that the crisis was merely an Anglo-Saxon problem. This view was epitomized by the German Finance Minister, Peer Steinbrück, who declared that 'this crisis originated in the US and is mainly hitting the US'.[5]

At that point euro area leaders thought Europe's banking system – with the few exceptions listed above – would be largely unaffected by the turmoil in Wall Street and London. The Spanish Prime Minister, José Luis Rodriguez Zapatero, declared that Spain's financial system was 'perhaps the most solid in the world',[6] reflecting a widespread view that the Spanish central bank had a good regulatory record. This was in stark contrast to the harsh criticism directed at the Financial Services Authority (FSA) in the UK.

In early October the G8 and G20 issued short statements[7] promising action to prevent the failure of systemically important institutions, ensure access to liquidity and capital, preserve depositors' confidence, and restart securitized markets. By mid-October 2008 the British government, led by Gordon Brown, used public money to recapitalize two of Britain's biggest banks, RBS and Lloyds HBOS. This *de facto* nationalization was criticized at the time, but with hindsight was necessary to avoid a systemic collapse.

While during those crucial early days of the crisis the UK and the US took strong measures to calm markets and regain control, the euro area's response was timid and uncoordinated. On 30 September 2008 Ireland took the decision to protect Irish depositors and guarantee its entire banking system. This unilateral action by a small country heavily exposed to the UK and US financial systems set back the possibility of common action by euro area policy-makers for some considerable time.

On 4 October, at an emergency meeting of the heads of state of the four largest euro area economies, the German Chancellor, Angela Merkel, refused to agree a concerted pan-European rescue plan for the euro area financial system.[8] The following day the German government issued a unilateral state guarantee for deposits in German banks. Ten days later it also established a special financial market

4 Sorkin (2010).
5 Cited in Benoit (2008).
6 Cited in *El Mundo* (2008).
7 G7 Finance Ministers and Central Bank Governors (2008).
8 Pisani-Ferry and Sapir (2009).

stabilization fund with guarantees for the German banking system of up to €400bn, which was later used in 2009 to recapitalize Commerzbank and several Landesbanken.

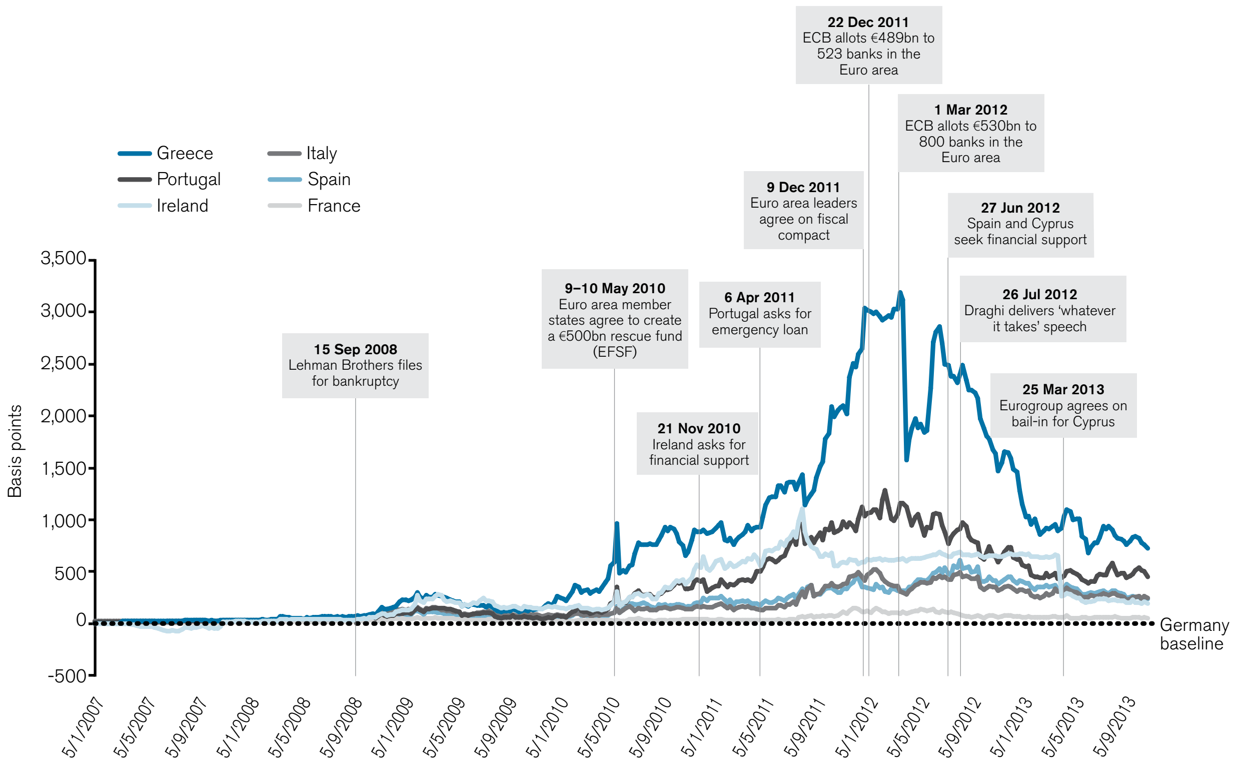
At this stage it was clear that the fall-out from the US subprime crisis had hit the euro area harder than European policy-makers had expected, and the priority of each country was to save its own banks. And the ECB agreed on 8 October 2008 to implement extraordinary liquidity measures for euro area banks.

Phase 2: a fiscal crisis?

In 2009 what began as a financial crisis quickly became a wider economic crisis. In the last quarter of 2008 and the first quarter of 2009 output fell across the board. Global trade collapsed, and in 2009 the global economy suffered the worst recession since the Great Depression, with output falling by 0.7%. The contraction in the euro area was even worse, with GDP falling by 4.2%. The situation was especially traumatic in Eastern Europe, which (after years of reliance on capital inflows from the euro area) suffered a series of sudden stops as capital flows dried up. Given the severity of the recession, G20 leaders agreed a coordinated stimulus package in April 2009.[9] China's stimulus was the biggest in relative terms, representing 13% of GDP, while that of the US – the biggest in absolute terms – was over 5% of GDP. In the euro area, Spain and Germany implemented stimuli of close to 4% GDP, and that of France was near 2%.

Fiscal stimulus measures alongside falling tax revenues and the impact of automatic stabilizers resulted in an increase in debt-to-GDP ratios among European economies from a pre-crisis average of around 61% to 74% in 2009. In some countries, the fiscal position deteriorated even more rapidly because of a number of factors including

Figure 1: Bond yields over German bunds



Source: Bloomberg.

9 G20 (2009).

high pre-existing levels of debt (Italy), large and expanding public spending (Greece), a rapid drop in growth and consequently in fiscal revenues (Spain and Portugal), and a large bank bail-out (Ireland).[10]

The case of Greece became particularly worrying at the end of 2009 when the newly elected government led by George Papandreou recognized that the country's debt levels had been seriously understated. This was confirmed in January 2010 when a European Commission report revised Greece's 2009 budget deficit upwards from 3.7% to 12.7%. The implied rise in Greece's debt-to-GDP ratio to over 110% spooked international investors, who had started to reassess default risks since the collapse of Lehman Brothers. Greek government bond yields went from near-parity with German bunds before 2008 to double-digit levels.

However, policy-makers in the euro area again misdiagnosed the situation. The initial reaction was that Greece was too small to matter. Then, when market contagion spread to Portugal, Ireland, Italy and Spain, the general assessment in Brussels and the 'northern' countries was that the problem was fiscal profligacy in these countries. Consequently the necessary remedy was seen to be further fiscal consolidation, which became the political focus. Over the coming months the Greek crisis deepened – Greece announced a series of ever-larger spending cuts, while negotiations began over an emergency loan from the International Monetary Fund (IMF). At the same time, much work at the technical level was being done on fixing the problems in the financial system that had been exposed by the crisis.

Meanwhile the euro depreciated sharply and interest rates on sovereign bonds of other euro area periphery countries started to climb (see Figure 1). Market contagion was rife, while the stronger members of EMU were unwilling to act. Germany in particular held back, in part because of upcoming regional elections in North Rhine Westphalia in early May 2010. During this period Germany insisted that the Maastricht Treaty did not allow for bail-outs of other euro area member states, and that therefore the correct strategy was to negotiate an IMF loan with possible further financial help from EU countries (similar to loans previously agreed for the Baltic states and Hungary). France, backed by the ECB, was reluctant to involve the IMF in solving the euro area's problem.[11] Finally, after several weeks of intense negotiations, in early May 2010 euro area leaders agreed to offer Greece a €110bn emergency loan.

However, markets remained unconvinced and the spreads between German bunds and bonds of peripheral euro area member states (including Portugal, Italy, Ireland, Greece and Spain) continued to rise. Under enormous market pressures, and lobbying from the United States, euro area leaders finally agreed to establish a €500bn European rescue fund (the European Financial Stability Facility – EFSF),[12] which would be topped up by an extra €250bn from the IMF.[13] The solution was a compromise between France and Germany. Berlin finally agreed to large financial guarantees, while insisting that the EFSF would be an intergovernmental body and that the IMF would be involved in the design and assessment of the support programme, joining the European Commission and the ECB as part of the Troika.[14] Nevertheless, the creation of the EFSF marked the first time euro area member states had agreed to issue a commonly backed debt instrument (a proto-Eurobond).

A number of other key decisions were taken over the historic weekend of 8–9 May 2010 which would then set the pattern for future negotiations and crisis resolution mechanisms. In exchange for the creditor states agreeing to finance the EFSF, peripheral countries (especially Portugal and Spain) accepted far-reaching cuts in public expenditures. Following this first compromise between creditor and debtor countries, the ECB took the radical decision to buy sovereign debt bonds from euro area countries with liquidity problems, through a new

10 Subacchi and Pickford (2012b).
11 Atkins et al. (2010).
12 The amount available to be used was initially much less, in order to preserve the EFSF's AAA status. The EFSF's lending capacity was then increased over the following months to reach €500bn. This was also then assured with the introduction of the ESM, given that it had €80bn of paid in capital provided by member states.
13 Council of the European Union (2010).
14 For a thorough account of these negotiations, see Barber (2010).

Securities Markets Programme (SMP). For critics, this marked a significant step towards breaching the Maastricht Treaty ban on monetary financing – two German ECB executive members (Jürgen Stark and Axel Weber) stepped down in response. Also this was the first time that the link was made between euro area leaders agreeing to bold structural reforms towards further integration, and the ECB responding with crucial emergency support.

Nevertheless, the SMP proved insufficient on its own to halt the crisis. Its limited amounts (only a little more than €200bn was disbursed) and the disclosure (at German insistence) of bond purchases every week limited the ECB's capacity to act as an effective lender of last resort for euro area sovereigns.

Over the next few months euro area policy-makers constantly tried to calm financial markets without success. In July 2010, the European Banking Authority (EBA) published the outcome of its first stress test of the health of European banks, but markets were unconvinced by the results. Panic in the markets escalated in the months leading up to the 18 October 2010 Franco-German summit in Deauville, which announced the two countries' agreement to establish a permanent replacement for the EFSF – the European Stability Mechanism (ESM) – by mid-2013. But the Deauville declaration also emphasized that any new sovereign rescue package financed by the ESM would include private-sector involvement (PSI).

This was a final recognition by euro area policy-makers that countries like Greece might be suffering a solvency crisis and not just a liquidity problem. However, the announcement of the ESM only created more uncertainty, by raising the possibility of debt restructuring in the midst of a financial crisis without explaining the details of how the new procedure would work. As a consequence, Ireland and Portugal saw their financing costs soar and this prompted the Irish sovereign bail-out in November 2010.

The Irish case was very different from the Greek one, however. As a result of its earlier decision to bail out its entire banking system, the Irish budget deficit for 2010 rose to 32% of GDP. In 2007 at the start of the crisis Ireland's debt-to-GDP ratio was 23% (the lowest in the euro area); by 2011 it was close to 100%. Unfortunately, the very different causes of the crises were not taken into account at the time. The common diagnosis among officials in Brussels, Frankfurt and Berlin was that these were primarily fiscal crises, and that the correct response in all cases was more intense fiscal consolidation. This call for austerity was supported by ECB president Jean-Claude Trichet who wrote in the *Financial Times*: 'stimulate no more – it is now time for all to tighten'.[15]

Phase 3: a banking crisis?

Unsurprisingly, after implementing concerted fiscal adjustment across the euro area, from mid-2010 onwards euro area output started to decline (see Figures 2 and 3). The first half of 2011 saw a marked worsening of the situation. Policy-makers in the euro area tried to respond to market turmoil with numerous piecemeal solutions (the European semester, second stress tests, pact for the euro etc.) but without a clear strategy on what emergency actions needed to be taken to respond to the unfolding crisis and what long-term reforms were needed to make EMU more sustainable.

The biggest problem remained the fragility of the euro area banking system, which was highly integrated before the crisis. As a result banks in the creditor countries were heavily exposed to problems in the peripheral countries. The Bank for International Settlements (BIS) estimated that by the first quarter of 2010 both the French and the German banking systems each had around €500bn exposure to the GIPS (Greece, Ireland, Portugal and Spain).[16] With widespread market panic, banks in the northern countries tried to unwind this exposure as soon as possible, thus aggravating the financial situation of sovereigns and banks in the crisis countries. The outcome was that by April 2011, Portugal had to ask for a rescue package involving even more fiscal austerity.

15 Trichet (2010).
16 BIS (2010).

After the collapse of Portugal, bond markets looked to see which would be the next domino to fall. Spain and Italy came into the firing line, and interest rates on their 10-year bonds rose steadily over the 5% mark, with a premium of 300 basis points over German bunds. Nevertheless, the policy response was still timid and focused on controlling fiscal budgets.

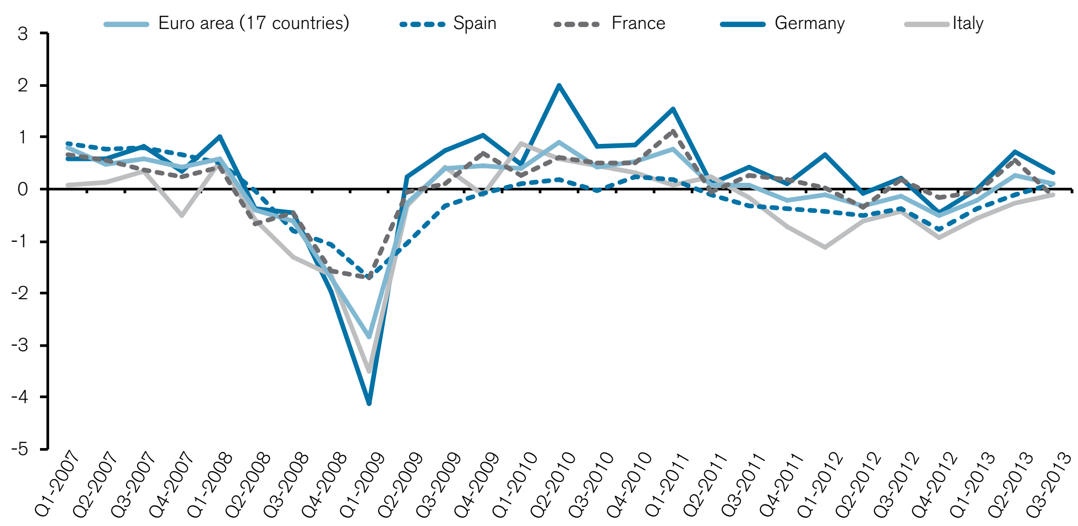
EU leaders pledged in several European Council meetings that they would do 'whatever is needed' to preserve the integrity of EMU, but there were no further bold actions to bring the crisis to an end. On the contrary, the dominant view in northern countries was that market pressure was a useful mechanism to force leaders in southern members states to implement the necessary structural reforms. At this point the ECB started to become a powerful political actor, utilizing its leverage to push for more integration and reform. In August 2011, Trichet sent two secret letters (later disclosed) to the Italian and Spanish prime ministers seeking further fiscal adjustment (including a debt brake in national law on the German model) and structural reforms in exchange for ECB intervention in the secondary bond markets. When Mario Draghi took over as ECB president late in 2011, the ECB strategy of requiring reform in exchange for emergency assistance became very public.[17]

In the face of this further fiscal austerity, at the end of 2011 the euro area entered a double dip recession with unemployment hitting record levels.

At the G20 meeting in Cannes on 4 November 2011, euro area policy-makers were openly criticized for their mismanagement of the crisis, and on 1 December Draghi declared to the European parliament that 'other elements might follow', implying that the ECB was ready to act, 'but the sequencing matters'.[18] EU leaders were urged to move first and demonstrate their commitment to EMU by signing a fiscal compact.

The response to the crisis was led by a small group of key actors, including the French and German heads of government, the presidents of the Council and Commission, the Commissioner for Economic and Monetary Affairs, and the heads of the Eurogroup and the IMF. This group started to work closely together at the end of 2011, and their response measures included the enlargement of the EFSF facility, increasing the IMF lending capacity to cope with a possible bail-out of Spain or Italy, and convincing other euro area leaders to sign

Figure 2: GDP growth rates (% Q1 2007–Q3 2013)

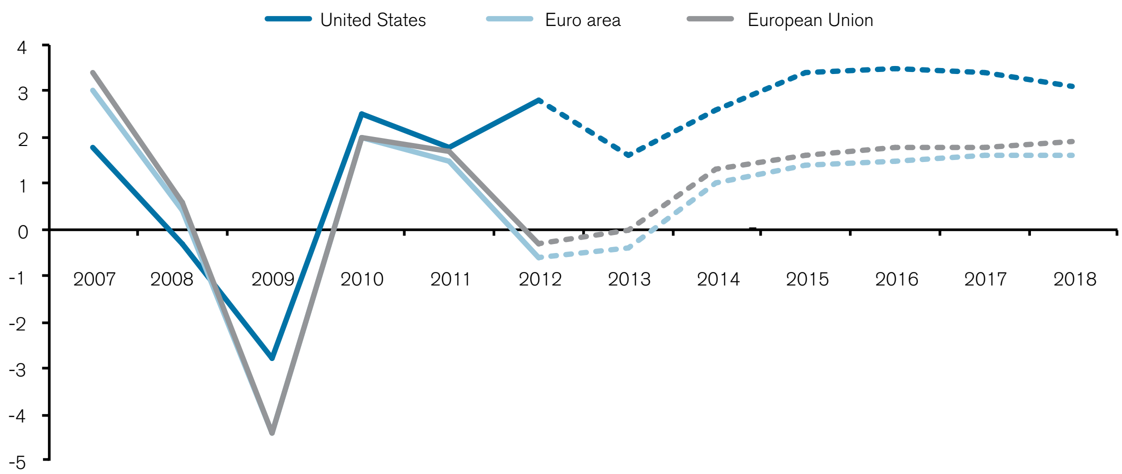


Source: OECD.

17 For an analysis on the games of chicken played between creditor countries, and the ECB and debtor countries, see Bergsten and Kirkegaard (2012a).

18 Cited in Atkins and Carnegy (2011).

Figure 3: EU and US growth rates (% 2007–18 est.)



Source: IMF WEO database, October 2013.

up to the Fiscal Compact, which (among other things) enshrined the 'debt brake' rule of balanced budgets for all euro area members.

The signing of the Fiscal Compact marked a watershed in the resolution of the crisis. Although it is an intergovernmental agreement (partly because the UK refused to sign up to an EU-wide instrument), it signifies a strong commitment by euro area member states to cede further sovereignty and control to the union. It was also a big victory for Merkel, who was able to explain to the German public that fiscal rectitude was now accepted by all euro area member states. The Fiscal Compact served also as the green light for Draghi to continue with the sequencing of reforms and initiate his measures to re-establish confidence with the markets. On 22 December 2011 the ECB offered €489bn in its first allotment of Long Term Refinancing Operations (LTROs) to the euro area banking system. The second allotment on 1 March 2012 provided another €530bn of extra liquidity.

Between these two events, euro area leaders finally agreed (after six months of hard negotiations) a second €130bn rescue package for Greece (which for the first time included PSI), totalling 53.5% of overall Greek debt (close to €200bn). This made it the biggest sovereign debt restructuring in modern history.

However, the LTROs and the second Greek rescue package did not calm the markets. Market participants rapidly realized that the LTROs were reinforcing the vicious circle between ailing banks and struggling sovereigns in the periphery. They also had doubts that Greece, facing a general election in May 2012, would be able to implement the tough austerity measures required by the Troika under the conditionality of the second rescue package.

Two fundamental problems started to worry markets. The first was the possibility that Greece would be forced, or would choose, to exit the single currency (the so-called 'Grexit'). The second was the banking crisis in Spain, which had been hit further by two recessions in three years. The previously mismanaged Cajas[19] were failing one after another, following the bursting of the real-estate bubble. The Spanish government now faced a similar situation to that of Ireland in 2010. But with a GDP of over $1 trillion (and assets of Spanish banks totalling 320% of GDP),[20] Spain was too big to fail and

19 Garicano (2012).
20 IMF (2012).

too big to be rescued by the ESM. The only institution capable of rescuing Spain was the ECB.

It was only now that policy-makers in the northern creditor countries started to accept that, while fiscal profligacy was at the heart of the problems in Greece, a major cause of the instability in the rest of the euro area was the current account imbalances that had built up within EMU over the previous ten years. These imbalances were due partly to a lack of productivity in the south, but also to the fact that the ECB's single monetary policy had been too loose for countries such as Spain and Ireland, which had experienced real-estate bubbles fuelled by cheap finance from the creditor countries. Policy-makers also realized that the banking crisis had been exacerbated because the two stress tests conducted under the auspices of the EBA, but undertaken by the national regulators, had not been effective enough in exposing the underlying problems in many European banks (having failed to address the quality of banks' balance sheets and the valuation of assets marked to model). The Spanish bank Bankia, for instance, had passed the stress tests, but eventually was discovered to have a €23bn hole in its balance sheet.

The prospect of Grexit and a default by Spain caused huge panic in financial markets. By May 2012 the interest rate spread for 10-year Spanish and Italian bonds reached 500 basis points, which was the level that had triggered the rescue programmes for Greece, Ireland and Portugal. Confronted with this situation, the ECB started again to press national governments for further structural reforms. Although there were strong demands from Madrid and Rome for it to intervene, the ECB did not budge.[21] Only when, in June, in response to the Spanish government's request for a €100bn rescue package for its banking sector from the ESM, euro area leaders agreed to set up a banking union, did Draghi make his 'whatever it takes' speech, which finally convinced markets that the ECB was ready to extend its role to become the *de facto* lender of last resort for euro area sovereigns.[22]

Phase 4: from crisis to reforms

Draghi's speech in July 2012 was extraordinarily effective in calming markets. Since that point bond spreads have started to converge again. A number of other factors also contributed to this trend. Before the summer of that year, Greece formed a grand coalition government led by Antonis Samaras, and Spain and Italy announced far-reaching structural reforms. In September 2012 the ECB introduced its Outright Monetary Transactions (OMT) programme, which differed from the previous SMP in two main respects. The ECB declared that its bond-buying capacity was unlimited in scope and duration, but it also made it clear that for the programme to be activated a country needed to apply for an ESM financial support programme and accept its conditionality.[23] It was this latter feature that made the programme acceptable to the German government, which publicly sided with Draghi against the Bundesbank.[24] In October 2012 Merkel took another big step in dissipating market fears about a possible Grexit by visiting Athens and declaring that Germany wanted Greece to remain in EMU.

However, once market pressures began to abate, euro area policy-makers started to return to putting their own national interests foremost. In a joint statement on 25 September 2012, the finance ministers of the only three remaining AAA creditor countries (Germany, the Netherlands and Finland) declared that direct recapitalization of national banks by the ESM would only be available for future banking crises, and not for legacy debt arising from the current crisis, thus preserving the vicious circle between banks and sovereigns. ESM funds approved for Spain would also remain loans to the Spanish sovereign and not pan-European loans directly for recapitalizing the Spanish banking sector. Policy-makers from creditor countries realized that a fully operational banking union with a single supervisory mechanism (SSM), a single resolution mechanism (SRM) and a single deposit insurance scheme (SDS) implied

21 For an analysis of the negotiating strategy of the ECB with euro area member states, see Bergsten and Kirkegaard (2012b).
22 Draghi (2012).
23 At the time market observers thought that the most likely candidate would be Spain.
24 The Bundesbank considered the OMT programme to be an indirect means of state financing and therefore in breach of the Maastricht Treaty.

creating a fiscal union by the back door, and they were not ready to take this huge step without having a high degree of centralized control over fiscal policies in EMU. For this reason progress in creating the elements of a banking union has been slow.

Nevertheless, in December 2012 the four presidents (of the Council, the Commission, the Eurogroup and the ECB, under the leadership of Herman Van Rompuy) produced their report on 'Genuine Economic and Monetary Union'.[25] In it they laid out the sequencing needed to build first a banking union, and then a fiscal and economic union. The report also refers vaguely to the necessity of creating a political union that can legitimize the entire process, but it provides no details. Since its publication in December 2012, the 'Four Presidents' report has been seen by euro area policy-makers as the roadmap to follow.

In March 2013 the crisis returned to the headlines when Cyprus required a bail-out programme. Although the situation was badly managed by both the Cypriot government and the Eurogroup (which at first agreed on a deposit tax that would hit savers with less than €100,000 – the amount insured by law across the EU – and then

Table 1: Key dates in the global and European financial crisis

09-Aug-07	ECB injects €95bn in banking system
15-Sep-08	**Lehman Brothers files for bankruptcy**
02-Apr-09	G20 leaders agree concerted stimulus plan
21-Oct-09	Greece revises 2008 deficit from 5% to 7.7%
08-Jan-10	EC revises Greek government 2009 deficit from 3.7% to 12.5%
02-May-10	Euro area member states approve €110bn emergency loan for Greece
9–10 May-10	**Euro area member states agree to create a €500bn rescue fund (EFSF)**
10-May-10	ECB introduces Securities Markets Programme
23-Jul-10	EBA publishes results of first stress tests
18-Oct-10	**Franco-German summit in Deauville agreeing future PSI**
21-Nov-10	**Ireland asks for financial support**
01-Jan-11	Three regulatory agencies (EBA, ESMA and EIOPA) start operating
06-Apr-11	**Portugal asks for an emergency loan**
15-Jul-11	EBA publishes results of second stress tests
21-Jul-11	Euro area leaders pledge to do 'whatever is needed' to save euro
13-Oct-11	Enhanced EFSF becomes fully operational
04-Nov-11	Rest of G20 leaders demand from euro area to take bold action
01-Dec-11	Draghi says sequencing matters, leaders should move first
09-Dec-11	**Euro area leaders agree on the terms of Fiscal Compact**
22-Dec-11	**ECB allots €489bn to 523 banks in the euro area**
21-Feb-12	Eurogroup approves second rescue package for Greece
01-Mar-12	**ECB allots €530bn to 800 banks in the euro area**
27-Jun-12	**Spain and Cyprus seek financial support**
29-Jun-12	Euro area leaders agree to create a banking union
26-Jul-12	**Draghi delivers 'whatever it takes' speech in London**
06-Sep-12	ECB announces technical features of OMT
25-Mar-13	**Eurogroup reaches agreement on bail-in process in Cyprus**
12-Sep-13	European Parliament approves single supervisory mechanism
18-Dec-13	Ecofin reaches agreement on single resolution mechanism

Source: Authors' elaboration.

25 Van Rompuy (2012).

reversed the measure), contagion from this crisis to other member states was only modest. This suggested that the overall framework of EMU, especially after the announcement of the OMT programme, had become more resilient. The Cypriot crisis, however, marked another turning point because it gave a clear message to the markets that from now on bail-ins would be a common feature in any future ESM rescue package. In other words, taxpayers' money would only be provided after shareholders, junior and senior bond holders and unsecured depositors had suffered losses.

The rest of 2013 was comparatively quieter. As growth remained elusive, there was a general realization that the negative multiplier effects of fiscal austerity were causing greater damage than previously thought. As a consequence, insistence on complying with the 3% budget deficit ceiling was softened and crisis-hit member states, including France, were allowed more time to reduce their deficits. The euro area as a whole has gradually started to come out of recession, although growth remains weak at present.

Progress on banking union has also been slow. The Asset Quality Review of the 130 biggest banks of the euro area did not begin until September 2013, and the ECB will start to function as the central supervisor (the SSM) only from around the end of 2014 or beginning of 2015. In December 2013, the European Council agreed technical details of the SRM, but the European Parliament sees the proposal as overly intergovernmental, and therefore negotiations will have to continue. Overall, the sense is that the ECB has calmed the markets for the moment, but in the absence of market pressure the urgency to introduce the necessary reforms is diminishing. This is a problem because ultimately until confidence in the euro area banking sector is restored, the flow of credit into the real economy will be restricted; and without credit, growth in the economy will not return.

3. Lessons from the Euro Area Crisis

EMU was an experiment without precedent in recent times. A large group of advanced countries took the decision to pool monetary sovereignty.

For nearly a decade after it was launched in 1999, the euro appeared to work well. In an environment of rapid international economic growth, low inflation and mild business cycles (the 'Great Moderation' period[26]), euro area countries experienced a spectacular convergence in interest rates, an unprecedented increase in financial interdependence and relatively high economic growth. In the period leading up to the global financial crisis the euro was regarded as a success. In fact, when the crisis started in 2007, the monetary union seemed to provide protection against the financial turbulence originating in the United States. It was argued that, without EMU, European countries could have entered the game of competitive devaluations and economic rivalry once again.[27] The euro was seen as shielding Europe.

However, this turned out to be a mirage. The global financial crisis ended up hitting euro area countries hard and exposed the deep vulnerabilities of EMU's original design.

There are important lessons from this crisis for the future of the euro itself. There are also implications for the theory of monetary integration. Some of these were anticipated long ago by economists who developed the theory of optimal currency areas (OCAs), which underpinned some elements of the design of EMU. As a result, some economists argued when the euro was launched that it would fail.[28] Other implications, however, have emerged from the crisis itself, and go beyond economics. They include political economy issues that were impossible to anticipate, highlighting the fact that economic and monetary integration cannot be fully understood without looking at the politics. And they also include a number of lessons for crisis management and financial contagion that emerged from the dynamics of the crisis itself and that could not have been anticipated.

This chapter draws out the main lessons from the euro area crisis. It argues that OCA theory provides a good benchmark for what is needed for a workable monetary union. But it also argues that a number of key political aspects are important too in assessing the economic and political requirements for the survival and success of a monetary union.

Revisiting the theory of optimal currency areas

There is a long literature on monetary integration and on what constitutes an optimal currency area.[29] The early consensus was that, given there would be only one interest rate across the currency area, business cycles should be synchronized in advance (as far as possible) between the members of the monetary union to minimize the costs associated with the loss of monetary and exchange rate independence. But since it was virtually impossible to ensure that business cycles are fully synchronized across heterogeneous economic regions, prices and wages needed to be flexible enough to facilitate adjustment, and the factors of production (especially labour) had to be highly mobile.

26 The first to coin this term were Stock and Watson (2002).
27 Wyplosz (2009).
28 Dornbush (1996).
29 Mundell (1961) and Kenen (1969), provide the cornerstones of the literature. See also De Grauwe (2006) for an analysis of the theory related to the EMU experience.

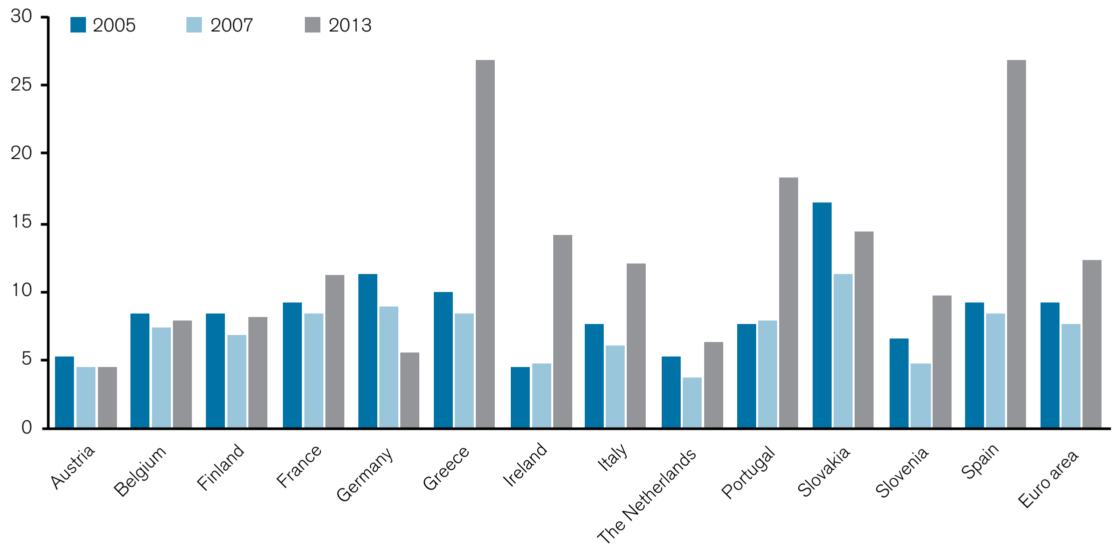
In sum, if markets were flexible and adjustment in the event of an asymmetric shock was possible and relatively painless, the cost of losing monetary and exchange rate autonomy would be low. This implied that the benefits of monetary integration (higher economic growth through expanded trade and competition) would outweigh the costs. On the other hand, if markets and wages were rigid, as adherents of the New Keynesian school of macroeconomics argue, losing control over domestic monetary policy would be very costly, as adverse asymmetric shocks could condemn members of the currency union to a long and painful adjustment process.

The euro area crisis strongly suggests that, in this respect at least, the New Keynesians were right.[30] The experience of southern European countries since 2009 shows that, without the capacity to devalue the currency and without sufficient factor flexibility, the internal devaluation needed to adjust to adverse shocks produced a deep recession, persistent high unemployment (see Figure 4) and deflationary pressures (particularly in the absence of fiscal and banking unions, as discussed below).[31]

Moreover, the hypothesis that currency unions can become 'more optimal' over time because increased trade and financial interdependence help to synchronize business cycles and facilitate the convergence in productivity levels across regions (an argument made by the European Commission in 1990 before launching the euro[32]) has also proved too optimistic. Intra-euro area trade has increased substantially over time, especially since the launch of the euro. But despite this there has been relatively poor convergence between members in terms of inflation and productivity, and low levels of labour mobility. Also, unemployment and inflation shocks in one part of the euro area seem to persist much longer than in a comparable situation in the United States.

In fact, one unanticipated lesson from the euro area experience is that once countries join a currency union and experience rapid economic growth, low interest rates

Figure 4: Unemployment rates (%, 2005–13)



Source: Eurostat (2014).

30 Krugman (2012).

31 Crafts (2013) has argued that remaining within the euro area today is as damaging for economic growth as was staying on the Gold Standard during the 1930s. However, there are important differences between the Gold Standard and the euro. The euro area does have a central bank capable of creating liquidity. In fact, the TARGET2 system, the payment and settlement tool used by the ECB for transactions in the Eurozone and for the calculation of debt obligations, shows that during the crisis the central banks of the peripheral countries have obtained financing from the Eurosystem (and thus accumulated liabilities) while the central banks of the northern creditor countries have accumulated the corresponding claims on the Eurosystem. In sum, EMU allows for much more flexibility than the Gold Standard. A different issue is that so far, unlike the Federal Reserve or the Bank of England, the ECB has been reluctant to pursue aggressive monetary policy. And perhaps more importantly, as we will discuss below, the euro is a political project, which makes it a completely 'different animal' from the Gold Standard.

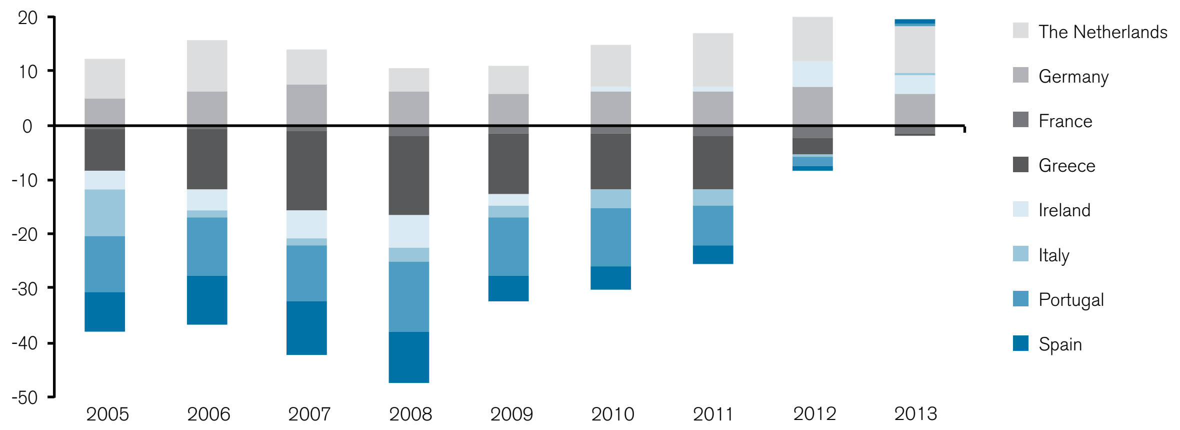
32 Commission of the European Communities (1990).

and large capital inflows (as was the case in the periphery members up to 2007), the incentives to implement the structural reforms (which would make their economies both more flexible and more convergent) weaken. Fernandez-Villaverde et al. show[33] that political leaders in the periphery countries found it difficult to implement the necessary structural reforms in the good times that followed the creation of the euro. Indeed, the incentives worked in the opposite way: given the absence of centralized macro-prudential financial policies and the weak mechanisms to ensure economic policy coordination (which were based on the ineffective open method of coordination), governments felt no pressure to control credit growth. They were also reluctant to enact politically controversial labour market, pensions, fiscal or education reforms that would have enhanced the flexibility of their economies and their competitiveness, by increasing their potential economic and productivity growth.

The macroeconomic Great Moderation (characterized by falling interest rates, low inflation, low volatility of economic output and large capital flows from the core to the periphery of the euro area after 1999) helped to convince governments that structural reforms were not so necessary, at precisely the time when they were most needed. Equally, asset bubbles (in countries such as Spain or Ireland) masked the need to run tighter fiscal policies in the good times to offset a single monetary policy that was too loose for these economies.

In fact, deeper trade and financial integration within the euro area facilitated the build-up of enormous macroeconomic imbalances during the first decade of EMU (see Figure 5).[34] Germany, the Netherlands and Finland (and to a lesser extent Austria and Belgium) recorded large current account surpluses. Conversely, Spain, Greece, Ireland and Portugal (and to a lesser extent Italy) accumulated large current account deficits, which translated into growing levels of foreign debt and deteriorating international investment positions (see Figure 6).[35] During that period, the current account of the euro area as a whole was roughly in balance (as was that of France), but internal macroeconomic imbalances were as large (in relative terms) as global macroeconomic imbalances (which were recognized at the time as a source of great concern for the stability of the global economy). However, these imbalances were not regarded as problematic because it was assumed that trade imbalances within a monetary union did not matter.

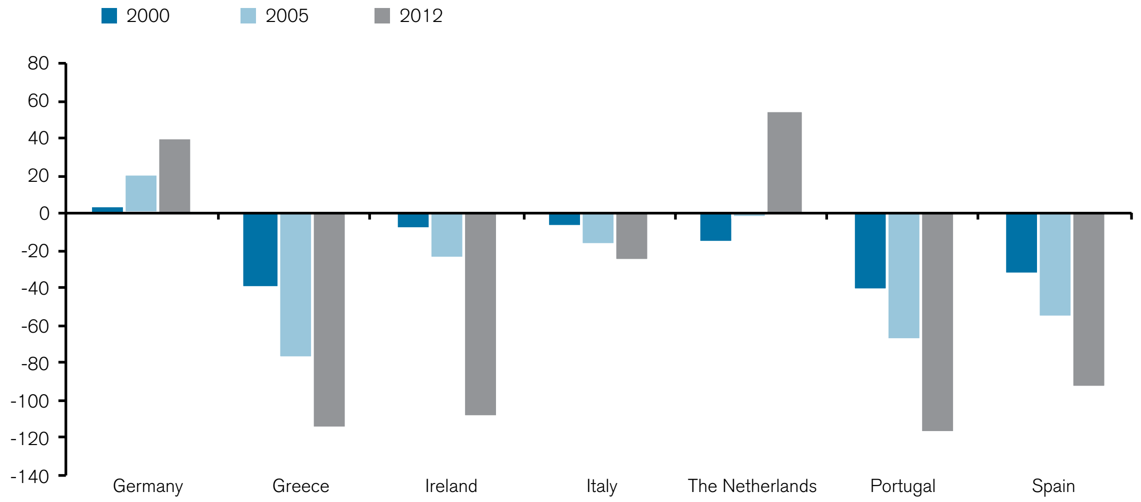
Figure 5: Current account balance (% of GDP, 2005–13 est.)



Source: Eurostat (2014).
Note: The bars show the cumulative totals of the individual deficits and surpluses of the countries shown.

33 Fernandez-Villaverde, Garicano and Santos (2013).
34 Guerrieri (2012).
35 From 2000 to 2008 the average current account surplus of Germany was 3.5% of GDP, for the Netherlands it was 5.4% and for Finland 5.6%. Conversely, during the same period, the average current account deficit of Portugal was 9.7% of GDP, while the Greek and Spanish deficits were 9.2% and 6.2% respectively.

Figure 6: Net international investment position (% of GDP, 2000–12)



Source: Eurostat (2014).

The underlying reason behind the accumulation of these current account misalignments was the divergence in real exchange rates between the core and the periphery. Inflation and unit labour costs grew more rapidly in the southern countries (and in Ireland) than in the centre, resulting in appreciating real exchange rates (see Figure 7). In particular, Germany's 'flexible' domestic labour market institutions (and falling real wages through the 'Great Moderation') gave it a key adjustment advantage under the euro, allowing it to pursue an export-led growth strategy and to run growing current account surpluses with its euro area partners.[36] Thus EMU rules bolstered Germany's creditor status. On the other hand, the countries in the periphery, whose economies were growing above their potential and whose tradeable sectors were losing competitiveness as inflation increased and productivity growth stagnated, did not take measures to correct these macroeconomic disequilibria.

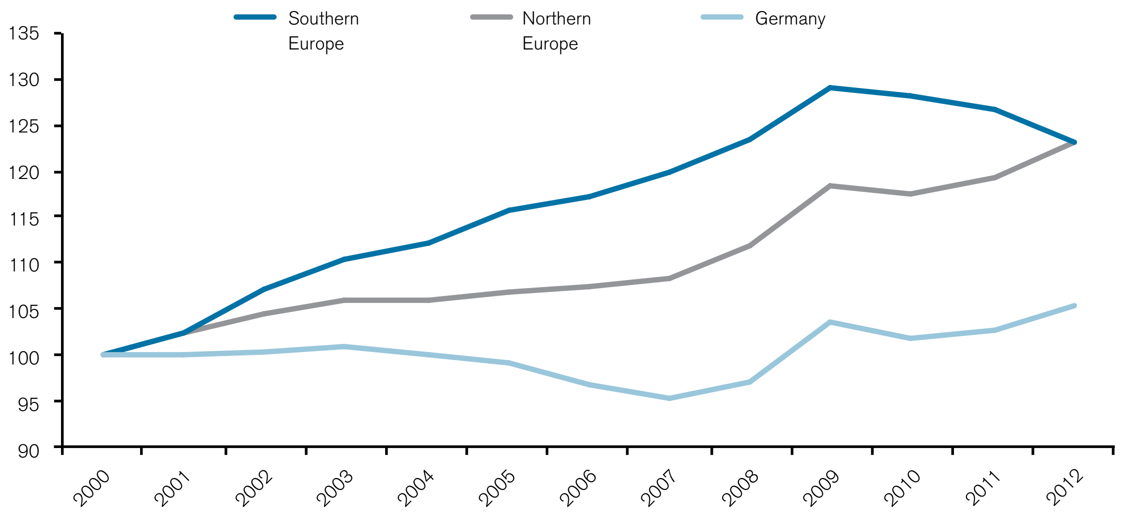
Financial markets were willing to finance these macroeconomic imbalances during the first decade of the euro. However, when the Greek crisis generated a 'sudden stop' in capital flows to the periphery in 2010, these countries were no longer able to finance their current account deficits, and were forced to adjust abruptly.

One lesson from this experience is that a sustainable monetary union has to incorporate mechanisms to monitor private-sector flows and to guarantee that governments undertake the necessary structural reforms to ensure that large macroeconomic imbalances, which can generate dangerous spillovers within the monetary union, are corrected when they appear. This, in turn, requires not only incentives to ensure economic reforms at the national level, but also a substantial degree of coordination of national economic policies, which implies giving up important portions of national sovereignty.

Optimal currency theory pointed out that, in the absence of sufficient economic convergence between the different regions of a monetary union, fiscal transfers would be indispensable to offset asymmetric shocks. Given the likelihood that one region would be experiencing a boom while another was in recession, a 'one size fits all' monetary policy would be problematic. In the absence of sufficiently high labour mobility, it would be necessary to establish some form of fiscal union by which a centralized institution could collect taxes from

36 Vermeiren (2013).

Figure 7: EU unit labour costs (2000–12) (2000=100)



Source: OECD.

the region or state that was experiencing relatively high economic growth and transfer part of those resources to the depressed regions, as is the case in the United States. The absence of an effective fiscal union in the euro area before the crisis – there were rules in the SGP to control deficits, but they did not work effectively, and the EU budget was too small to play this role – reinforces this argument, developed by Kenen,[37] and suggests that it is one of the most essential elements for a workable monetary union.

Both the IMF[38] and the European Commission[39] have argued that a fiscal union in the euro area is necessary. However, fiscal union implies much more than just transfers across regions. It requires strong and credible budgetary surveillance mechanisms for countries in order to avoid moral hazard problems, and the collection of euro-area-wide taxes to raise revenues, as well as some sort of centralized debt instrument to fund a common budget and ensure debt sustainability. The problem is that an ambitious fiscal union cannot be established without some sort of political union to legitimize transfers. And political union was not included in the initial design of EMU.

Beyond optimal currency theory: lessons from the crisis

There are also various lessons from the euro area crisis that were not fully anticipated in the theory of optimal currency areas. The most important is that monetary unions among sovereign states need a sovereign lender of last resort (LOLR) function, and a banking union with a common fiscal backstop (to avoid financial fragmentation and to break the link between banking and sovereign debt).

Euro area countries have learnt the hard way that joining EMU meant that they were issuing debt in a currency that they did not control. Even though the ECB was intended to be the central bank of all member states, the fact that it has a mandate centred solely around inflation and is forbidden to purchase sovereign debt in the primary markets or monetize deficits (in many ways mirroring the responsibilities of the German Bundesbank) meant that peripheral countries experiencing speculative attacks could not rely on the ECB to stabilize their debt markets. Countries following the Gold Standard had a similar experience.

37 Kenen (1969.
38 IMF (2013).
39 European Commission (2012).

As De Grauwe (2011)[40] has argued, there is a need for a central LOLR role in the euro area in relation to government bond markets. The government of a country with its own currency can give an implicit guarantee to ensure that there is adequate liquidity in its bond markets. In contrast, in a monetary union, national governments have to rely on the issuer of the single currency to provide liquidity. And in its absence, liquidity problems can mutate into solvency problems. Before 2012, when the ECB launched the OMT programme, it had no modality to act as a LOLR for sovereigns.

It remains to be seen if OMT will be effective (since it has not yet been activated, and it faces continuing legal challenges from Germany). But it seems clear that a workable monetary union should have a central bank that is perceived by international investors as able and willing to act in exceptional circumstances as a sovereign LOLR. This might require a change in the ECB's mandate to authorize monetary financing in extreme circumstances when there are speculative attacks that threaten the survival of the currency union. But since this would have significant fiscal and redistributive implications, it involves entering the delicate terrain of political union.

A second element not anticipated by OCA theory is the need to have a banking union, which includes a common supervisor, a common resolution mechanism and a common deposit insurance scheme (the last two having access to a common fiscal backstop). The launch of the euro generated a rapid integration of member countries' financial markets, but supervision remained at the national level. As the crisis unfolded and a number of large banks experienced liquidity and solvency difficulties, two problems emerged. First, the process of financial fragmentation and renationalization of financial systems meant that increasing amounts of sovereign debt issued by each country were held on the balance sheets of that country's banks, thereby increasing their exposure to potential sovereign default. Second, as markets perceived that some countries might struggle to service their debt, the possibility of a sovereign default increased the risk that the national banks would also become insolvent. A negative feedback loop between banks and sovereigns emerged. These problems, in turn, distorted the transmission mechanism of monetary policy, raising interest rates in countries experiencing this negative feedback loop and making credit much more expensive.

As a consequence, the lack of an effective mechanism to break the 'doom loop' between banks and sovereigns amplified the divergence between the economic performance of the core and the periphery countries: credit flowed from the depressed southern members to their more competitive northern neighbours, thus increasing growth in the creditor countries and deepening the credit crunch (and the recession) in the debtor countries. The lesson is therefore clear: a sustainable monetary union requires a central authority to supervise large banks and operate macro-prudential tools; and it needs a common resolution authority with access to sufficient fiscal resources to recapitalize (and resolve) banks without endangering the solvency of individual countries. Finally, there needs to be a common insurance deposit scheme to ensure citizens and investors that all deposits are equally safe regardless of the bank or country in which they are held. But, since a fully-fledged banking union implies a degree of fiscal integration to finance bank bail-outs and guarantee deposits, it again requires a degree of political union.

The euro area crisis also provides an important lesson about the behaviour of financial markets. Far from operating smoothly and in an efficient way, they have overreacted (both positively and negatively) to developments in the euro area. During its first decade, they did not know how to interpret EMU. The rapid convergence of sovereign bond yields (by which Greece, Portugal or Spain could finance their debt just some basis points above Germany) shows that markets thought sovereign risk had effectively disappeared with the creation of the euro. Similarly, as the crisis unfolded, they overreacted by pooling funds from debtor to creditor countries. The herd behaviour of financial markets, or their tendency to panic and overshoot, is well known in the finance literature. What is new, however, is that markets have found it hard to assess and interpret the meaning of EMU because it is a

40 De Grauwe (2011).

currency without a state behind it. Once again, a sustainable currency union has to answer one crucial question: which political sovereign is backing the currency?

Finally, given the impossibility of anticipating financial crisis, a monetary union requires crisis resolution mechanisms capable of responding in a credible, fast and efficient manner to unexpected events. The euro area did not have these mechanisms in place. The decisions taken by its leaders were perceived as doing too little, too late. Since markets respond much more quickly than political institutions (especially when decision-making requires a high degree of consensus-building), a monetary union that is not a state requires a clear structure of decision-making which has control over resources and can act quickly. Since the beginning of the crisis, the euro area has made progress in this front. The ECB and the ESM are now capable of responding to crisis situations. However, more remains to be done. The capacity of US institutions to respond rapidly to the financial crisis in 2008 is a good example of a more effective crisis resolution mechanism, despite the difficulties in persuading Congress to provide resources.

The necessity of political union

It is clear that monetary unions need to be backed up by adequate political institutions and governance structures capable of responding in times of crisis. The original euro area design was sufficient for good economic times, but was clearly not well suited for the challenges posed by deep financial crisis.

Since it is virtually impossible to meet the conditions of an optimal currency area, a monetary union needs to be underpinned by a degree of fiscal union, banking union and economic union. However, all these imply some level of political integration to legitimize the substantial pooling of sovereignty involved.

Moreover, a degree of political union is also necessary to convince financial markets that the monetary union is backed up by a sufficiently credible political structure. This point is well illustrated by the fact that investors did not question the viability of the US monetary union during the global financial crisis because the dollar is underpinned by a unitary state. Speculation against the sovereign debt of peripheral euro area countries during the crisis, on the other hand, was exacerbated by the weak political underpinnings of EMU. Questions were raised about the sustainability of the single currency and reintroduced a redenomination risk in financial markets.

Despite these shortcomings, member states have shown a high degree of political commitment to the euro, a commitment that has surprised many analysts through the crisis. Understanding the basis of this political commitment is important in assessing the future of EMU. As a number of scholars have argued,[41] it was not only an economic project. It was also political project and has to be looked at in the wider context of the process of EU integration. Seen from that perspective, EMU was just another step towards 'ever closer union'.

Early discussions about the single currency did acknowledge the need for eventual political union. Chancellor Helmut Kohl argued, in a 1991 speech to the German Bundestag: 'Political union is the indispensable counterpart to economic and monetary union. … It is fallacious to think one can sustain economic and monetary union permanently without political union.'[42] The Delors Report,[43] which provided the basis for the Maastricht Treaty, stated that EMU would require 'a high degree of compatibility of economic policies and consistency in a number of other policy areas, particularly in the fiscal field'. It also noted that the greater degree of integration between national economies would require 'more intensive and effective policy coordination, … not only in the monetary field, but also in areas of national economic management'.[44] In a similar vein, the late Tommaso Padoa-Schioppa, one of the key architects of the euro, argued in 2004 that 'the foundations of a stable currency cannot be guaranteed only by the Central

41 Marsh (2009); Pisani-Ferry (2012).
42 Kohl (1991).
43 Delors (1989), Chapter II, Section 1, Article 16.
44 Ibid., Chapter I, Section 4, Article 12.

Bank. They have to be underpinned by a number of elements that only a State or a political community can provide.'[45] More recently, De Grauwe has restated this idea by arguing that 'The euro is a currency without a country. To make it sustainable a European country has to be created.'[46]

EU leaders acknowledged the need for a political union to sustain EMU. However, in the early 1990s there was no political agreement to go that far, mainly because France was reluctant to give up so much fiscal and economic sovereignty. This, in turn, led Germany to push for a limited model of monetary integration based on an independent and orthodox central bank, tight controls on fiscal policy and no fiscal transfers.[47]

The current crisis has provided an opportunity to strengthen the weak original design of EMU to make it more sustainable by adding the necessary elements of fiscal, banking, economic and political union. The Commission's Blueprint for a Deep and Genuine Economic and Monetary Union has outlined the main steps and the timeline required, starting with banking union and proceeding then with fiscal and economic union. In the next chapters we assess the progress that has been made so far and the gaps that still exist.

45 Cited in Pisan-Ferry (2012), p. 43.
46 De Grauwe (2012).
47 Marsh (2009).

4. Policy Responses: Recent Reforms and Plans

There have been many reform initiatives since the onset of the crisis, covering all aspects of economic policy – fiscal, financial, monetary and structural. Big steps have been taken to strengthen economic policy-making within Europe. In some cases they have been built on existing structures. But in others, new governance structures – frameworks, processes and institutions for policy-making – have had to be created. Overall, they have followed the roadmap envisioned in the 'Four Presidents' report to create a Genuine Economic and Monetary Union, as well as the more detailed proposals made by the European Commission's Blueprint.

This chapter outlines the policy reforms that have already been put in place or proposed, both to manage the crisis and to introduce more substantive reforms, and it assesses their effectiveness so far.

Fiscal policy

Much of the initial reform effort was concentrated on strengthening structures for surveillance of fiscal policies across the EU, and in particular the euro area.

Fiscal discipline

This focus on fiscal policy reflected the view strongly held by many of the 'core' countries, with relatively strong fiscal positions, that lax fiscal policies were at the heart of the problems faced by periphery countries. As a result the fiscal surveillance framework has been strengthened to impose more discipline on 'debtor' countries (see Box 1). This discipline was the quid pro quo for additional solidarity instruments, such as stronger firewalls and some degree of debt mutualization.

The 'preventive arm' of fiscal surveillance (the Stability and Growth Pact – SGP) has been strengthened through the provisions of the 'Six-Pack'[48] and the 'Fiscal Treaty'.[49] The 'Six-Pack' of regulations requires countries to make significant progress towards their medium-term deficit objectives (MTOs), and added expenditure benchmarks to help measure progress. The Fiscal Treaty establishes a balanced budget rule for all signatories,[50] and requires countries to incorporate debt brakes and national MTOs into their constitutional laws.

The 'corrective arm' (the Excessive Deficit Procedure – EDP[51]) has also been tightened, with stiffer penalties for non-compliance. The EDP was strengthened by the addition of a debt trigger (in addition to the deficit trigger) to launch an EDP, and a time-path for adjustment towards the 60% debt level. Sanctions have also been increased for breaches of the SGP, through a graduated system of non-interest-bearing deposits, interest-bearing deposits at the ECB and (ultimately) fines of up to 0.2% of GDP for non-adherence.

Within the euro area there have been further moves (through the 'Two-Pack'[52]) to synchronize national budgetary processes, in order to allow more coordinated scrutiny at the euro area level of national fiscal plans. National budgetary frameworks have been defined more precisely, requiring independent fiscal institutions[53] to

48 European Commission (2011).
49 European Council (2012).
50 All but the UK and the Czech Republic signed the Treaty on Stability, Coordination and Governance.
51 For all the technical details and up to date information on ongoing EDPs, see European Commission, Economic and Financial Affairs, Corrective arm/ Excessive Deficit Procedure: http://ec.europa.eu/economy_finance/economic_governance/sgp/corrective_arm/index_en.htm.
52 For more information on the 'Two-Pack' see European Commission (2013a).
53 For a comprehensive review on the process of creating independent fiscal bodies in euro area member states, see European Commission, Economic and Financial Affairs, Databases and Indicators, Independent Fiscal Institutions in the EU Member States, http://ec.europa.eu/economy_finance/db_indicators/fiscal_governance/independent_institutions/index_en.htm.

produce forecasts and monitor compliance with national fiscal rules, minimum quality standards, multi-annual planning and numerical fiscal rules. The timing of budgetary processes has also been defined through the 'European Semester', to standardize national timetables and allow the Commission to request revisions to draft budgets.

Box 1: Fiscal reforms

On 29 September 2010, the Commission presented legislative proposals for economic governance reforms:

- Reinforcing the Stability and Growth Pact (SGP) by strengthening the preventive arm, increasing the emphasis on the debt criterion (the corrective arm), strengthening Eurostat's role in ensuring high quality fiscal statistics, and setting minimum requirements on national fiscal frameworks;
- Broadening surveillance to macroeconomic and competitiveness developments within the euro area (and within the EU); and
- More effective enforcement through appropriate incentives and early sanctions, with a semi-automatic trigger through reverse QMV decision-making.

As part of the Europe 2020 strategy, the European Semester is intended to harmonize and synchronize timetables for national budgets to allow greater coordination of economic policies. The Commission:

- Provides an annual assessment of national budgets; and
- Analyses the fiscal and structural reform policies of every member state, provides recommendations and monitors their implementation.

The 'Six-Pack' entered into force on 13 December 2011. This measure:

- Applies to all 27 member states and covers both fiscal and macroeconomic surveillance;
- Strengthens the SGP (which specifies that a member state's general government deficit must not exceed 3% of GDP and public debt must not exceed 60% of GDP);
- Operationalizes the debt criterion, so that an EDP may also be launched on the basis of a debt ratio above 60% of GDP (in addition to the deficit criterion); and
- Allows for financial sanctions on member states, which may eventually reach 0.5% of GDP.

Reverse QMV applies for most sanctions, as it does for the MIP, implying that a recommendation or a proposal of the Commission is considered adopted in the Council unless a qualified majority of member states vote against it.

Running in parallel with the Six-Pack, the fiscal part of the Treaty on Stability, Coordination and Governance (TSCG), referred to as the 'Fiscal Compact', introduced further disciplines:

- It requires each contracting country[a] to respect its country-specific medium-term objective (MTO), with structural deficits not exceeding 0.5% of GDP (1% for member states with a debt ratio significantly lower than 60%).
- Debt brakes are to be integrated into national constitutional law (through provisions of 'binding force and permanent character, preferably constitutional'). If the new rules are not implemented there are correction mechanisms with automatic action and monitoring by independent institutions (including financial sanctions of up to 0.1% of national GDP).

- Member states subject to the excessive deficit procedure (EDP) are required to adopt an economic partnership programme approved and monitored by the Council and the Commission

Building on the Six-Pack, the 'Two-Pack' entered into force on 30 May 2013. It aims to ensure that excessive deficits in euro area member states are corrected, and to establish enhanced surveillance of member states experiencing or threatened by financial difficulties:

- Under the first regulation, euro area countries will need to present their draft budgets to the Commission in October each year. The Commission has the right to assess these, issue an opinion on them and ask for revisions.
- The second regulation sets out explicit rules and procedures for enhanced surveillance of any euro area country facing severe difficulties with regard to its financial stability or receiving financial assistance.

a The Fiscal Compact has been signed by all EU member states with the exception of the Czech Republic and the United Kingdom. It has been ratified by 17 out of 18 euro area member states and seven other signatories. The TSCG is binding on all euro area member states. Other contracting parties will be bound once they adopt the euro.

Sources: European Commission website; European Council.

In the first, recently released reports on draft budgets for 2014 the budgets of five countries (Spain, Italy, Malta, Luxembourg and Finland) were found to threaten non-compliance with the Stability and Growth Pact. But so far the 'preventive' and 'corrective' mechanisms have neither prevented nor corrected excessive deficits.

Fiscal consolidation was needed in many of the euro area countries to restore debt sustainability. Countries with financial support programmes, in particular, faced requirements for severe fiscal consolidation.[54] But most of the fiscal reforms introduced over the past few years were designed to establish structures and processes to deliver fiscal sustainability in the medium term. They have been slow to be put in place and the effects on actual fiscal outcomes have been even slower. Instead, the related debate about the speed and depth of fiscal austerity has been played out primarily in the context of EU/IMF financial support programmes for the crisis countries. As a result, where fiscal consolidation has taken place it has been concentrated on deficit countries, so that at the euro-area-wide level fiscal policy has been tightened significantly.

These reforms represent a 'Maastricht 2.0', with more wide-ranging and stronger rules and more automatic sanctions. They build firmly on the Stability and Growth Pact, which dates back to the start of EMU and has a complicated governance structure, involving the Commission, the ECB and the member states.

The SGP has had a long but chequered history, and in the early days political expediency tended to dilute the process. From the outset the system had a degree of 'fuzziness', to allow decisions to be tempered by a degree of judgment.[55] So Greece and Italy were admitted to the single currency with public debts well in excess of the 60% level. And in the early 2000s France and Germany avoided fines for their breaches of the deficit ceilings, which led to the 2005 reform of the SGP.

These lenient judgments were helped by a decision-making structure that shared responsibility between the different institutions. The Commission was responsible

54 In its July 2011 Quarterly Report for the euro area, the European Commission envisioned for the period 2010–14 a reduction in government deficits of 7% in Spain, 5% in Greece, Ireland and France, and 4% in the Netherlands and Italy: http://ec.europa.eu/economy_finance/publications/qr_euro_area/2011/pdf/qrea2_section_1_en.pdf.

55 The Resolution of the European Council on the Stability and Growth Pact, signed in Amsterdam on 17 June 1997, and the reform agreement, signed in Brussels on 21 March 2005, have the 3% annual government deficit limit and 60%-to-GDP overall debt limit as 'reference values', which leaves ample room for ambiguity and discretion in imposing sanctions.

for operating both the preventive arm of the SGP (the surveillance mechanism) and the corrective arm. The ECB had no formal role in either process, although in practice its analytical input was an important part of the process. However, formal decisions on the surveillance conclusions and the EDP were taken by the European Council, if necessary by qualified majority voting (QMV). The involvement of the Council allowed the peer pressure of the surveillance process and the application of hard numerical guidelines for designing corrective measures (backed up where necessary by financial sanctions) to be diluted, as 'peer protection' came into play.

With one exception, the governance structures and responsibilities for administering the framework have not changed. The exception is potentially important – the Fiscal Treaty changes the EDP so that decisions are now taken by reverse QMV. As a result, it requires a qualified majority of member states to *prevent* the Commission's recommendations for corrective action from coming into force. This is potentially a powerful counterweight to 'peer protection'.

However, the incentive structures have not changed, which means that countries may seek to circumvent the new rules once the crisis has dissipated and market pressures have been reduced. Because the new fiscal processes are stronger and more binding, when disagreements arise between the central institutions and member states, they are also likely to be more acrimonious than in the past because more is at stake. Even though the new rules make it more difficult for member states to block sanctions, it is unclear if the European Commission will have the power to enforce sanctions on the more powerful states; and it is still possible for members to overrule the Commission. Overall, stronger rules cannot substitute for stronger fiscal and economic integration, which will require (as we argue later) the creation of new common institutions.

Fiscal integration

Although the disciplines on national budgets have been toughened and made more comprehensive, little has been achieved so far in terms of deepening fiscal integration across the euro area. There are EU-wide mechanisms which could perform that role, including EU 'own resources' and the cohesion funds. But as currently configured they are not well designed to play this role.

If anything, the appetite for transfers between member states has diminished over time; and as the total EU budget has been squeezed further (and specific policy areas, such as agriculture, have been protected) the available resources have been similarly reduced.

Additional instruments have been proposed that could carry out this function, either directly or indirectly. The Commission has repeatedly requested a larger central fiscal capacity for euro area countries, but it does not appear likely to be granted in the foreseeable future. The Commission has also proposed that additional fiscal resources, such as the proceeds of a financial transactions tax, should be made available for redistribution between member states. But even if the resources were provided (and at the moment it appears that there is little political will to do so) the Commission would need to design a system to calibrate the appropriate level of fiscal transfers between countries.

Indirect instruments could also play this role, and could be targeted better on weaker and more vulnerable countries; they also could operate semi-automatically, rather than requiring specific approval from EU institutions and the Council. For example, eurobonds (the joint and several liability of all euro area members) could enable transfers from stronger to weaker members, since they would be of greatest benefit to countries with poor credit ratings. To the extent that credit ratings are well correlated with strong economic performance and strong competitiveness, this would transfer resources appropriately. However, critics are concerned that these subsidies would induce moral hazard, so it would be necessary to have effective incentives in place for weaker countries to continue with policy reforms.

Another indirect instrument could be a bank resolution mechanism funded or backstopped by national budgets. To the extent that banking system weaknesses were linked to competitiveness problems, this mechanism could be appropriately targeted on weaker countries. However, it would only operate in circumstances where banks needed to be resolved, rather than providing ongoing transfers.

Finally, there has also been little progress in defining the appropriate fiscal stance at the level of the euro area in aggregate. The European Semester provisions have the potential to do so, since the Commission can question individual national budgets. But since it is a recent development there is little evidence that this is happening systematically yet.

Financial policies

Much emphasis has also been placed in recent years on mending financial systems and correcting the shortcomings in regulation that were seen as having played a major role in the crisis.

Crisis responses

The immediate priority in dealing with the crisis was to provide sufficient liquidity to financial systems, as European banks struggled to access financing in capital markets. As detailed in Chapter 2, the ECB acted early to provide liquidity through conventional market operations. But as the crisis deepened and spread to more countries in Europe, the ECB was forced to significantly expand its role in providing liquidity through a range of instruments, including the SMP, LTROs and (most recently) the OMT scheme.

In addition to liquidity operations, in the early stages of the crisis the emphasis was on fixing and resolving banks in difficulty. And in the absence of pan-European institutions with the necessary financial resources and powers, much of this was left to national governments. Early moves to halt financial panic by guaranteeing depositors in troubled banks also fell to national governments, with Ireland and Germany moving unilaterally to protect their depositors.

These national initiatives helped to protect national banks and their depositors, but given the high degree of financial integration in Europe, they also caused serious problems for other countries and forced them to respond. They also exacerbated moves towards financial fragmentation, as countries sought to protect their own institutions and depositors by imposing higher capital and liquidity requirements on parent banks, causing them to retreat from overseas branch business (in particular in the periphery countries within Europe).

Reforms to the financial system

In addition to managing the crisis, there have been many reforms to the structure of the financial sector and the way it is regulated. This section outlines the main changes made, and further changes planned, to financial regulation, supervision, resolution of failing institutions, deposit guarantees and macro-prudential policies.

Early on in the process of reforms to produce a more integrated European financial system, a pan-European structure for **regulation** was set up. The European System of Financial Supervision (ESFS) was created, together with three European agencies for banking, markets, and insurance and pensions (EBA, ESMA, EIOPA[56]). These agencies were given a mandate to put in place a single rule-book for the financial sector in Europe. The three agencies have independent status, but in practice their decisions are generally subject to scrutiny and approval by both the Commission and the Council.

The three agencies are now responsible for most of the technical legislation relating to the financial sector, which is binding on all member states. This has been a controversial issue, since this area is decided by QMV; but important parts of the financial sector are located in non-euro area countries (especially the UK and Sweden), and there were fears that the euro area members (which have an inbuilt qualified majority) could impose changes against the interests of non-members. The Council agreed that decisions would require a double QMV, of both euro area members and non-members.

56 The European Banking Authority (EBA) in London, the European Securities and Markets Authority (ESMA) in Paris and the European Insurance and Occupational Pensions Authority (EIOPA) in Frankfurt were established at the end of 2010. Together with the European Systemic Risk Board (ESRB) they form the European System of Financial Supervision (ESFS). Its principal task is to coordinate more effectively national supervisions of the financial sector. See http://ec.europa.eu/internal_market/finances/committees/index_en.htm#maincontentSec2.

On supervision radical changes were proposed by the 'Four Presidents' report in December 2012.[57] This outlined a framework for European-level supervision (the single supervisory mechanism centred around the ECB), as part of its wider proposals for a banking union.

After an acrimonious debate about the respective powers of the ECB and national supervisors, the single supervisory mechanism was agreed, and approved by the European Parliament in September 2013. The ECB is now actively planning to take on its formal responsibilities as direct supervisor of the largest euro area banks later in 2014. This will take place after the Asset Quality Review (AQR) of the largest European banks, to establish the current state of banks' balance sheets using a common reference point.

If financial institutions are so weak that they need to be recapitalized or closed down, a **resolution** process is also needed. The IMF has consistently criticized European supervisors for failing to deal quickly or forcefully enough with bad legacy assets on banks' balance sheets, by requiring recapitalization or closure of failing banks.[58]

The Four Presidents report also proposed a 'single resolution mechanism' (SRM) to deal with failing cross-border institutions, which would be responsible for deciding what action needed to be taken and which had sufficient financial resources at its disposal. But again this has proved controversial. The December 2013 Council summit came forward with a proposed intergovernmental structure for the SRM, which will impose industry levies but take several years to reach a reasonable financial size. It has also been criticized[59] as being unwieldy and complex, making it difficult to reach decisions, since it involves the ECB, the SRM board and the EcoFin Council (which has the last word on any resolution procedure).

The bail-in rules for EU-financed support programmes have also been approved, following the programme for Cyprus. This is important, as it is a clear attempt to formally involve the private sector in bank resolution. However, it is not certain how strictly these rules will be applied to all euro area crisis countries in the future, given their inconsistent application to date.

Despite the call in the Four Presidents report for the harmonization of **deposit guarantee** schemes, there has been little progress in establishing a common deposit insurance mechanism. Again, it has proved difficult to reach agreement because there are potentially large fiscal implications. There is already a common minimum level at which national schemes have to guarantee deposits in the event of a bank failure. But there are a variety of ways in which these guarantee schemes are funded. From January 2015 common *ex ante* financing arrangements using bank levies will be introduced, to achieve a minimum target level of 0.8% of guaranteed deposits. But there is no binding mutualization of depositors' protection across countries.

Development of **macro-prudential policies** is still in the early stages. At this point the governance structures are better developed than the policy instruments, with the creation of the European Systemic Risk Board (ESRB). This body is closely linked to the ECB, although formally separate from it.

The ESRB was set up in December 2010 to carry out macro-prudential oversight of the European financial system. The ESRB is nominally independent,[60] but it is supported and housed by the ECB. Its chairman is the president of the ECB, and most of its board members are also members of the ECB's general council

Obstacles to completion

This longer-term agenda to improve integration of the financial system in Europe and deliver a banking union remains a work in progress, with much still to be implemented and some of the very important details still to be decided between the European Parliament and the Council. Also it will be a number of years before all the elements are fully in place.

The most controversial element has been the degree to which the **cost of resolving failing institutions** is shared

57 Van Rompuy (2012).
58 See, for example, IMF (2011).
59 Gros (2013).
60 The ESRB is regulated under TFEU, Article 114 as a body without legal personality and with no binding powers.

across the euro area. The cost could be considerable in the period before sufficient financial resources have been accumulated through industry levies, and countries are unwilling to commit budgetary resources without sufficient control over the decisions about which institutions should be resolved. But until a common fiscal backstop for resolving banks and guaranteeing deposits is in place, it will be difficult to break the feedback loop between sovereign and banking debt, to complete the single market in financial services, and to ensure that countries are not vulnerable to sudden stops.

There are also likely to be **coordination problems** between the different institutions involved in financial policy. With separate institutions responsible at the European level for regulation (the European Supervisory Authorities, ESAs), supervision (the ECB), resolution (the SRM board), and macro-prudential policies (the ESRB), it will be important that these institutions are fully engaged with each other, given the strong interlinkages between their mandates. In reality the ECB is likely to play a coordinating role, given its involvement in the ESRB and the SRM board, and the strong links between regulators and supervisors. But this raises further issues about the democratic legitimacy and accountability of the ECB itself. Taking the Bundesbank as a model, the founding fathers of the Maastricht Treaty considered that the ECB needed to be fully independent in order to conduct monetary policy effectively, but they did not envisage this expansion of its powers.

There are also likely to be further coordination problems between European-level institutions and national bodies. National supervisors will be responsible for sharing the supervision of institutions below the level of the ECB's remit, but in practice it will be important that all supervisory agencies exercise their judgments consistently in order to preserve a level playing field. Also national central banks are likely to have considerable responsibility and discretion for setting and implementing macro-prudential policies at the national level, and the ECB will have an important role in ensuring some consistency across Europe.

Even more importantly, there needs to be strong coordination between financial policy and fiscal authorities. Many of the decisions taken by the ECB on supervision, and especially by the SRM board, could have profound implications for member states, which will for many years have to provide a fiscal backstop. The involvement of the EcoFin Council in resolution issues will be crucial in ensuring that the fiscal consequences are taken into account.

As argued in Chapter 3, a further obstacle is the absence of a comprehensive **lender of last resort**[61] within the euro area, both to support banks which are illiquid but solvent, and to be the ultimate lender to national governments *in extremis*. The latter role is explicitly ruled out by the ECB's statutes through the ban in the Maastricht Treaty on monetary financing. This is entirely consistent with the trend towards central bank independence over the last 30 years; but in unitary states, parliaments can override the central banks' independence in extreme circumstances. There is no such provision for the ECB, short of a treaty change.

Moreover, to date the ECB has not been in a position to act as a lender of last resort to banks, although the launch of the OMT scheme has moved it closer to this position.

This role will become even more important as the SRM is put into place. But with three separate institutions responsible for the traditional roles of the central bank in this area – the ECB to make supervisory judgments about individual banks, the ESRB to assess systemic risks, and the SRM board to decide on how to act on failing banks – the system will be extremely complex to operate. This may be problematic when speed of action will be at a premium. It remains to be seen whether this system is capable of resolving failing banks over a weekend.

Economic policies and structural reforms

It has long been recognized that structural reforms are essential to help improve Europe's poor growth record. More recently they have also been seen as necessary to improve the functioning of EMU and address problems of competitiveness.

61 Bagehot (1873) provides the classic definition of a lender of last resort for illiquid banks.

There are concerns also that insufficient policy coordination within the euro area is leading to a deflationary bias because in following policies to address imbalances the burden of adjustment is concentrated on the deficit countries.

Structural reform policies

Structural policies present a dilemma for EMU. On the one hand, structural reforms to deliver greater flexibility in labour and product markets are necessary for the effective functioning of the single currency area, as set out in Chapter 3. But on the other hand the measures that need to be undertaken are primarily country-specific, and implementation requires a high degree of country ownership.

There is a long history of attempts by the EU to push forward structural reforms. The Lisbon Process and Europe 2020 strategy set up detailed processes to identify and encourage countries to implement necessary reforms (see Box 2). Despite these initiatives by the Commission to introduce Europe-wide perspectives to structural reforms, its open method of coordination has been largely ineffective. And despite the efforts put into these, neither Lisbon nor Europe 2020 has achieved much.

More recently the pace of reforms has increased. But in most cases this has been under pressure from the crisis, especially in hard-hit countries with financial support programmes. Greece, Portugal, Ireland, Spain and Cyprus have all substantially reformed their financial systems after

Box 2: The Lisbon Process and Europe 2020 strategy

Launched in 2000, the Lisbon Process was intended to boost growth, create jobs and foster innovation in Europe in the face of globalization.

It set up National Reform Programmes (NRPs) in several areas: public finance, education, research and development, the business environment and labour markets. Strengthening social cohesion and the mobilization of national and community resources were encouraged by the Council. The programmes varied considerably across member states, from the formulation of the targets to their implementation. The Lisbon strategy also allocated EU structural funds for R&D projects.

Following on from the financial crisis, the European Commission launched in March 2010 the Europe 2020 strategy to meet the challenges of the next decade. This aimed to deliver smart, sustainable and inclusive growth. Five headline targets were agreed for the whole EU:[a]

- **Employment:** 75% of 20–64 year-olds in employment;
- **R&D:** 3% of the EU's GDP invested in R&D;
- **Climate Change and Energy Sustainability:** a 20% reduction in greenhouse gas emissions, 20% of energy coming from renewables, and a 20% increase in energy efficiency;
- **Education:** at least 40% of 30–34 year-olds to complete tertiary education, and the rate of early school-leaving reduced to below 10%; and
- **Fighting Poverty and Social Exclusion:** Lowering the number of people in or at risk of both poverty and social exclusion to below 20 million.

These key targets, to be pursued through a mix of national[b] and EU action, are set for 2020, and are mutually reinforcing. Investing in education should help employability, and a strong R&D sector linked to clean technologies should create new business and job opportunities.

a Different targets were set by member states in their National Reform Programmes in April 2011.
b European Commission (2011), *Europe 2020 Targets*, http://ec.europa.eu/europe2020/pdf/targets_en.pdf.
Source: European Commission website.

their bail-out programmes. In response to the conditions set by the Troika for financial support, aggressive labour market reforms have been adopted. These have facilitated wage flexibility and internal devaluation to reduce current account deficits, but have failed, so far, to provide strong job creation. As part of the fiscal consolidation efforts, tax codes have been rewritten (in most cases to raise revenues) and spending on health, education, unemployment benefits and pensions has been slashed. There have been limited efforts to introduce more transparency and meritocracy in public administration, reform education systems and R&D policies, liberalize goods and services markets and ensure increased price competition.

Overall, member states have been reluctant to accept a role for European institutions in structural policies, an area that has traditionally been seen as the preserve of nation-states. But given the importance of structural reforms to EMU, the Commission has recently revived the idea of incentivizing countries to introduce structural reforms through contracts for financial support.[62]

The Four Presidents report has also argued that reforms are needed to address excessive divergences in competitiveness within the euro area. It calls for a stronger framework for coordination and convergence of structural policies, and backs a contractual approach. While recognizing that a country-specific approach is needed, it argues that this should be mandatory for all euro area countries (not just for those in crisis) and that incentives for implementing reforms should be provided through 'targeted, limited and flexible financial support'.

Macroeconomic imbalances

The reform process has also been extended to broader macroeconomic policies. Before the crisis macroeconomic policies at the European level largely operated in silos. Monetary policy was the preserve of the independent ECB, and most governments were very reluctant even to comment on monetary matters. Fiscal policy remained largely the responsibility of national governments, except in extreme circumstances when the EDP process could start to bite.

One consequence of this lack of coordination was that the loss of competitiveness suffered by many countries[63] (especially in the periphery) went largely unrecognized through the 2000s. The low interest rates and high economic growth in many countries that followed the creation of the euro masked the importance of imbalances, and blunted the incentives to correct them. This was also exacerbated by an overall appreciation in the value of the euro against the dollar and other currencies,[64] as the ECB followed a relatively tight monetary policy and the euro was increasingly used as a reserve currency.

Another manifestation of this problem was the inappropriate mix between monetary and fiscal policies for many countries. For example, the credit booms and asset bubbles experienced in Spain and Ireland in the mid-2000s was (in hindsight) a signal that the stance of the single monetary policy was overly loose for these countries, and that they had failed to tighten fiscal policy sufficiently. The resulting inflation was one of the factors behind the loss of competitiveness which ultimately contributed to the crisis.

This problem was eventually recognized, and the 'Six-Pack' introduced a new process to prevent and correct macroeconomic imbalances and changes in competitiveness. In what has potentially been the most important reform so far in addressing the competitiveness issue directly, the Macroeconomic Imbalances Procedure (MIP) was agreed in December 2011 and the first round of reports were completed in November 2012 (see Box 3).

The intention behind the MIP is to take a comprehensive look at a country's policy stance and to identify weaknesses or inconsistencies that have implications for the stability of the entire euro area. The MIP operates in a similar fashion to the SGP, with a preventive and a corrective arm. The European Commission produces a yearly Alert Mechanism Report based on a scoreboard of indicators, which helps to identify countries and issues for which an in-depth review is deemed necessary. If this deeper analysis finds that macroeconomic imbalances are severe and dangerous, the Commission can recommend to the Council that it should start an Excessive Imbalances

62 European Commission (2012).
63 Guerrieri (2012).
64 The euro appreciated 86% between 2002 and 2008. See http://www.ecb.europa.eu/stats/exchange/eurofxref/html/eurofxref-graph-usd.en.html.

Procedure (EIP), by which a country would be required to make substantial policy changes in order to reduce imbalances. If these are not eliminated, sanctions can be applied, but only for euro area member states with current account deficits.

This process has limited reach, however. The single monetary policy is taken as given, so actions to correct imbalances have to be focused on fiscal, macro-prudential and structural policies in particular. Also, it is far from clear that the mechanism will be applied symmetrically, so that there are pressures on surplus countries, as well as on deficit countries, to adjust. For example, in the first round of scoreboards the indicator thresholds for triggering an in-depth review were set at 4% of GDP for current account deficits and 6% for surpluses. This is consistent with a more generally held view that EMU puts more of the burden of adjustment for addressing imbalances on countries running deficits (both external and fiscal) than on surplus countries. The EIP's greater tolerance of surpluses than of deficits reflects 'northern' countries' interests.

Although the MIP is relatively new, the early reports from the process are not encouraging. The MIP can only be activated *ex post*, when imbalances appear. And it is a slow and politicized process. Full coordination across the range of economic policies would require an *ex ante* effort to coordinate across euro area countries, including symmetry of adjustment between surplus and deficit countries.

There is also now a greater focus at the Council level on macroeconomic management with at least two Eurogroup meetings each year at heads of state level to coordinate macroeconomic policies.

Box 3: The Maroeconomic Imbalance Procedure

The Macroeconomic Imbalance Procedure (MIP) agreed in December 2011 has the following elements:

- **An early warning system:** The Alert Mechanism Report is the starting point of the annual cycle of the MIP. A scoreboard of eleven indicators, covering the major sources of macroeconomic imbalances, identifies member states with potential risks based on threshold triggers.[a] The aim of this process is to establish whether emerging economic imbalances are problematic. If required, the European Commission can send missions (with the ECB) to countries.
- **Preventive and corrective action:** The Commission and the Council can adopt recommendations to prevent economic imbalances from developing. These recommendations are contained in the package of country-specific recommendations which the Commission puts forward in May/June each year as part of the European Semester preventive arm. The MIP also has a corrective arm which can be applied in more severe cases, through an Excessive Imbalance Procedure (EIP). The country in question then has to prepare a corrective action plan with a clear roadmap and deadlines, and to submit regular reports on progress.
- **Rigorous enforcement:** For euro area countries there is an additional enforcement regime:
  - A country may have to place an interest-bearing deposit at the ECB after one failure to comply with the recommended corrective action.
  - After a second compliance failure, this interest-bearing deposit can be converted into a fine (up to 0.1% of GDP).
  - Sanctions can also be imposed for failing twice to submit a satisfactory corrective action plan.

All decisions which might lead up to sanctions are taken using reverse qualified majority voting, so that the Commission's proposals will be approved by the Council and implemented unless a qualified majority of member states votes against them.

a The thresholds and the scoreboard are not applied mechanically, but there is a discretionary element.
Source: European Commission website.

Crisis management

Apart from the broad range of structural reforms to European economic governance in recent years, much political energy was spent initially on managing the crisis. In addition to the ECB's actions to inject liquidity into the financial system, the initial round of responses to the banking crises was left to countries themselves to manage. But as the crisis spread to sovereigns, and it became clear that it extended further than one or two countries, new mechanisms to address these issues and attempt to prevent contagion to other countries were needed.

Early in the crisis a decision was taken to put in place financial support programmes in conjunction with the IMF. This introduced its own tensions, as the individual members of the 'Troika' (the Commission, the ECB and the IMF) had different views on the appropriate policy actions required in programme countries. Over time, as Europe built up its financial resources to use in support of crisis countries, the IMF has stepped further back.

The financial resources within Europe were initially provided by countries' contributions to purpose-designed institutions set up under the auspices of the Commission (the EFSF). This has now been superseded by the ESM, which also has the power to borrow from markets with guarantees provided by the main contributing countries.[65]

The process of reform

Much has been achieved over the last five years. But the process of reform to economic governance has been slow and painful. It has been hampered by political disagreements, with even relatively minor decisions requiring many Council meetings and summits to achieve. To illustrate the point, there have been more Council summits since 2008 than there were in well over a decade before that. Even then, big decisions have needed the impetus of a crisis to reach agreement. Spain represented a tipping-point in the policy response to the crisis. When Spain requested a bail-out package for its ailing banks (especially the Cajas), European policy-makers realized that this fourth largest economy in the euro area was too big to fail and too big to provide with a comprehensive rescue package.

Taken together, all these changes to macroeconomic, structural and financial policy arrangements have resulted in a significant shift of power and responsibility to the European centre, and to creditor member states. In many areas there has been greater centralization of responsibilities, with more detailed rules and stronger sanctions on members, although the only truly Europe-wide instrument currently is the single monetary policy.

Coordination of fiscal policy has also been strengthened. The Commission's role, in particular, has been strengthened by the move to reverse QMV for the EDP. The Commission also has a stronger coordinating role with responsibility for the SGP and MIP processes. However, with responsibilities still concentrated at the national level, it is very difficult to determine fiscal policy across the euro area in aggregate.

More generally, even for policies which are designed and implemented at the European level, coordination is made more difficult by the division of responsibilities between the various European institutions: the ECB, the Commission and European agencies (such as the financial supervisory agencies – EBA, ESMA, EIOPA – the ESRB and the ESM).

65 The European Stability Mechanism (ESM) has become the permanent financial stability fund for the euro area. It started to operate in mid-2013 and it has a lending capacity of up to €500bn, with a paid-in capital of €80bn. It has the capacity to issue joint debt instruments to cover the lending programmes of the rescued countries and it has also the capability to intervene in the primary sovereign debt markets of euro area member states in need. Its activation is always subject to a memorandum of understanding with attached conditionality. See http://www.esm.europa.eu/.

5. Building a Sustainable Euro Area

As the previous chapter set out, big steps have been taken to strengthen economic policy-making within Europe and make the euro sustainable. However, more needs to be done to ensure that EMU is not vulnerable to further crises, and there are big obstacles – mainly political – to putting these in place.

The policy changes and reforms identified as necessary for an effective EMU include steps towards fiscal union (including measures to ensure national fiscal sustainability and adequately funded fiscal transfers), macro-prudential and banking policies to ensure sustainable financial integration (with a common supervisor and a common mechanism to resolve failing financial institutions, as well as a common deposit insurance scheme), and an economic union to facilitate convergence of competitiveness across the euro area. These reforms are deeply interconnected, and need to be closely integrated. This requires a legitimized governance structure that also allows the relevant policy-making bodies – both national and European – to coordinate their actions.

The design of governance structures can be crucial in determining the efficiency and effectiveness of policy-making. This chapter builds on the conclusions of the previous ones, suggests ways to deliver the reforms that would make EMU fully effective and discusses the main obstacles to their implementation.

Fiscal union

The euro area needs to take a further step to create a comprehensive fiscal union. In the absence of greater fiscal integration, the strains within EMU are likely to erupt again from time to time.

Fiscal policies across Europe need to be credible and sustainable in order to avoid the market pressures that many countries experienced during the crisis. But they also need to be flexible enough to respond to country-specific shocks, and to ensure that the burden of adjustment to competitiveness gaps can be borne more symmetrically between 'surplus' and 'deficit' countries. Finally, they need to be better coordinated so that aggregate fiscal policy settings are set appropriately at the euro area level. A well-structured political dialogue between fiscal and monetary authorities will also be necessary.

There has been good progress in building structures to exert national fiscal discipline and improve policy coordination across the euro area. However, little has been achieved so far in terms of deepening fiscal integration so that transfers can offset country-specific shocks or inappropriate monetary policy settings. New fiscal rules alone, even if they are respected, will not be sufficient to solve future problems that arise from asymmetric shocks.[66]

What is needed is a new central fiscal capacity for the euro area capable of transferring funds to specific countries to fund euro area structural policies that will foster growth and competitiveness, and to set fiscal policy at the euro area level. It will have to operate according to clear rules which are perceived as legitimate by euro area citizens. Ultimately, this will only be possible under a single central treasury function (a central fiscal authority) within the euro area with powers to require changes to national budgets, to determine fiscal transfers, and eventually to issue debt and collect (directly or indirectly) euro-area-wide taxes. National governments would still have the ability to raise revenues, determine expenditures and decide on the balance between tax and spending at the national level. But the overall fiscal position for the euro area as a whole would be set by the central fiscal authority, and debt issued centrally would be the joint liability of all euro area members.

66 The German Glienicker Group (2013) and the French Eiffel Goup (2014) of experts come to a similar conclusion.

Such a powerful supranational body would require strong democratic legitimacy and accountability, at both European and national levels. The head of this body – in effect the economics and finance minister of the euro area – should also be the president of the Eurogroup, be able to coordinate directly with the ECB and Council presidents, and report to the European Parliament. This individual could also be vice president of the European Commission.

The fiscal capacity could be funded through three potential channels. First, new euro-area-wide taxes, such as environmental taxes, a financial transactions tax or VAT could be collected. Second, resources could be received directly from member states. However, the system of contributions would need to be designed so as to ensure that no country will always be a net contributor or net recipient of the fiscal capacity (i.e. to avoid permanent north–south fiscal transfers, which would be politically unacceptable in creditor countries).

Thirdly, there should be the capacity to raise finance by issuing common debt instruments (short term eurobills and long-term eurobonds), which would be joint and several liabilities of all euro area members. These securities would have to be issued by a new euro area debt agency, and would involve implicit subsidies from countries with good credit ratings to those with lower ratings. They would also help to improve debt sustainability in all euro area countries since they would permanently reduce financing costs for the debtor countries.[67] Finally, they would deepen and widen euro area financial markets, which could lead to an expansion of the international role of the euro, reduce overall euro area financing costs, and increase Europe's international monetary influence. Critics are concerned that common debt would induce moral hazard, so effective incentives would need to be put in place for policy reforms in the weaker countries, including structural reforms and fiscal discipline.[68]

Determining how the fiscal capacity would spend its resources requires a technical assessment capability. The MIP has the potential to provide the analytical framework. The funds could be spent in areas capable of facilitating the convergence and competitiveness of euro area economies, in EU-wide investment projects, and in policies to offset negative asymmetric shocks and avoid negative spillovers across the euro area.

Examples of these projects could include energy and physical infrastructures, pan-European industrial and R&D policies, and a euro area unemployment insurance fund to protect cyclically unemployed workers in countries that have reformed their labour markets following the Commission's guidelines.

The fiscal capacity would complement the ESM, which is already functioning and provides temporary loans for countries experiencing financial and banking problems, and which issues 'small' quantities of common debt. As we will discuss in the following section, the common resolution and deposit insurance mechanisms of the banking union should ultimately have access to a common fiscal backstop, which should be larger than currently envisaged.

But ultimately decisions on the allocation of spending across the euro area are intensely political, and require a legitimate political structure to take them.

Banking union, macro-prudential policy, and the role of the ECB

The initial steps towards a banking union have already been taken. A single rule-book is already operating in the EU, and the SSM will be supervising the largest 130 banks of the euro area around the end of 2014. However, the SSM will increasingly extend its remit beyond the largest euro area banks. This process will take time, as it requires transferring human resources from national supervisors to the ECB; but beyond technical difficulties, serious political problems are unlikely to stand in its way.

There are much bigger problems, however, with the other two legs of banking union: the SRM and the insurance deposit scheme. The SRM still needs to incorporate a sufficiently large and credible common fiscal backstop. By 2026, the SRM is supposed to have a fund of €55 billion

67 For a study on how a Eurobond would reduce the financing costs of euro area member states, see European Primary Dealers Association (2008).

68 The Blue Bond or the Redemption Fund proposals could potentially be a solution because member states would remain individually responsible for debts over 60% and thus market discipline would be maintained. See Delpla and von Weizsäcker (2010), and Bofinger et al. (2011).

that will be progressively built up by taxing banks. In the event of bank failures, these private resources, together with those provided by the new bail-in rules, and complemented by the ESM (up to €60 billion), would provide an important cushion. However, only at the end of the transition period (up to 2026) will these resources be completely merged; until that point they will be partially divided into national compartments, with national authorities still in part responsible for recapitalizing their banks. This could be problematic because bank failures could put the solvency of states at risk once again.[69]

Another problem is the total amount of resources available. Given the size and scale of the euro area banking sector, which according to the EBA was close to €30 trillion in late 2013,[70] these resources would almost certainly be insufficient in the event of a systemic banking crisis affecting a number of financial institutions simultaneously. Either the ESM would have to be expanded substantially, or the SRM would require access to the central fiscal capacity envisaged above. Until that is in place, euro area member states will have to be prepared to use taxpayers' money as a backstop for the European banking system.

Finally, no progress has been made yet to create a common insurance deposit scheme. In order to ensure a level playing field between banks from different countries, there should be no doubt that deposits up to €100,000 in all the banks of the euro area would be protected. As in the case of the SRM, this requires a fiscal backstop ultimately linked to the central fiscal capacity and triggered by the SSM, to guarantee deposits if the SSM decides that a bank can no longer meet its liabilities. If a common single resolution fund is set up, the lack of a common insurance deposit scheme will create an incentive for the Single Resolution Board to shift the responsibility for resolving banks (especially smaller banks) back to countries in order to minimize the impact on the European fund. As a result the vicious circle between sovereign and banking risks would remain. One way forward is to establish a debt redemption fund, as proposed by the German Council of Economic Experts,[71] to deal with the problems of legacy debt. This could be set up on an intergovernmental basis, within the current treaty.

An ultimate goal of banking union should also be to increase competition in the banking industry across the euro area and to reduce 'home bias' in order to allow for the emergence of some pan-European banks that operate at the retail level in all euro area countries.

As part of the banking union, macro-prudential policies will have to play an increasingly big role both in reducing financial risks across the euro area and in adapting to country-specific circumstances. For example, macro-prudential policies were used in Spain before the crisis in order to lean against inappropriately easy monetary conditions (although unfortunately they were not as restrictive as turned out to be necessary).

Development of macro-prudential policies is still in its early stages. At this point the governance structures are better developed than the policy instruments, with the creation of the three European regulatory agencies and the ESRB (which is closely linked to the ECB). However, the European institutions responsible for macro-prudential policies will need to be closely coordinated. Fighting financial risks will be an important task across the entire single financial market, setting out guidelines for action, which are then implemented primarily by the SSM. The ESRB is the appropriate institution to carry out this role.

Macro-prudential policies will also need to be closely aligned with the single monetary policy. This suggests either that the ECB takes on this role fully for the euro area, or that a subset of the ESRB needs to be constituted, composed only of euro area members. This body would set more precise and binding national macro-prudential policy actions, but calibrated to suit distinctive national circumstances.

Since these actions will also have macroeconomic consequences, and may also have fiscal impacts (for example on tax receipts), the macro-prudential body for the euro area will also need to cooperate closely with the central fiscal authority.

69 The ECB has proposed to shorten the transition period to five years.
70 Jones (2014).
71 Bofinger et al. (2011).

The ECB, which has become one of the most powerful European institutions through the crisis, will have additional powers. Besides issuing the currency, it is increasing its influence over macro-prudential policies (through the ESRB) and financial policies (both directly, through its role in the SSM and in the Troika, and indirectly through its likely influence over the single resolution mechanism). It has the necessary independence and reputation, and the support of most member states, to sustain its policy autonomy, and it is able to implement the single policy stance across the euro area.

However, in the long run a sustainable monetary union in the euro area requires that the ECB can play the function of an unconditional lender of last resort for sovereigns in exceptional circumstances, as is the case for the Federal Reserve in the US or the Bank of England in the UK. This means that its mandate needs to be modified to allow for deficit financing when there is a speculative attack. In addition, given that the euro area as a whole faces important growth and unemployment challenges, its mandate, besides focusing on inflation, should also include provisions to promote economic growth, always in close coordination with the fiscal authority, the Eurogroup, and the other macroeconomic policy institutions.

Economic union

Structural policy initiatives at the European level have largely failed because the 'open method of coordination' did not provide the right incentives to introduce structural reforms. Reforms have been undertaken in many countries, but primarily at the national level and in response to market pressures (and in some cases imposed by the Troika). However, structural reforms are an important part of the changes needed to allow all euro area countries to live with the disciplines imposed by the single currency.

Given the wide diversity of economic structures across the countries of Europe, the precise nature of structural reforms and the priorities for action will be largely determined at the national level. However, the interconnections across the euro area, and the implications for other countries of failure to deliver reforms at the national level, mean greater coordination is justified. The failure to close competitiveness gaps across the euro area is one example of the costs of inadequate coordination.

It will not be easy to design structures and processes that will improve coordination while maintaining a national focus for action. But an institution is needed to coordinate structural policies across the euro area. The Eurogroup, whose president would also head the central fiscal authority, is probably the institution best suited for the task, since it can help to deliver buy-in from countries to the overall euro area programme for structural reform.

The Eurogroup should agree on priorities for action by each country, probably over a multi-year programme, given the long time-scale for delivering structural reforms. It should also analyse spillovers from one country to another from national structural policies and set incentives for countries to introduce reforms, with the capacity to impose sanctions. It could also establish minimum standards on key public policies, such as spending on R&D, transparency and meritocracy in public administration, or on the fight against tax evasion. It should also coordinate policies in the areas of labour market regulation, pensions and taxation. Finally, it should standardize and harmonize data collection in all areas of public administration (with periodic inspection visits to secure progressive convergence and increased transparency) so as to build trust in all euro area countries' public finances. The fiscal capacity should be used to provide resources for structural policies when they are deemed necessary.

Given the lead role of member states in designing and implementing structural reforms, this forum will need to engage countries fully and gain their ownership. Without national ownership, reforms are unlikely to be implemented effectively. Using the resources of the fiscal capacity to co-finance some of the reforms that require funding would facilitate the process and create positive incentives to implement them.

A key issue will be enforcement. A sound proposal, made by the Commission, is that countries sign binding contracts with the Commission under which they commit to structural reforms in exchange for specific resources to finance structural policies. If adequately designed, these contracts would provide the right incentives for countries to implement structural reforms in normal times (the Troika is already insisting on structural reforms and austerity measures for countries under an ESM programme).

A starting point to determine priorities would be to use the macroeconomic imbalances framework to identify necessary reforms. However, the mechanism should go much further because it should not act *ex post*, as the MIP does. Full coordination across the range of economic policies would require an *ex ante* effort to coordinate across euro area countries in order to ensure real economic convergence and avoid macroeconomic spillovers and competitiveness misalignments.

Policy coordination

The crisis exposed major shortcomings in the coordination of macroeconomic and structural policies in the euro area in particular. The design of the single currency requires much stronger coordination across all elements of economic policy.

An effective EMU requires a strong mechanism for coordinating fiscal and monetary policy. In addition (as argued above) macro-prudential policies need to be well connected with the single monetary policy, and with fiscal policies where there are implications. Similarly, structural policies need to be well coordinated with fiscal (and wider macroeconomic) policies.

It will be difficult and time-consuming to design mechanisms to achieve this level and breadth of coordination. A number of European institutions (each with its own mandate and responsibilities) will have to be involved. And in some areas there will be a strong national interest in the design of policies. There will be a particular problem in involving the ECB (and the single monetary policy), given its constitutional independence. But failure to coordinate effectively across all arms of economic policy is likely to result in inefficient policy settings, and in the extreme could generate similar pressures to those seen in recent years. Although still based on an intergovernmental approach, the Eurogroup is at present the institution best placed to coordinate national macroeconomic policies and assess how these affect (and are influenced by) the policies of the new central fiscal authority and the ECB. But it will be necessary to hold regular summits of the euro area heads of state to ensure proper coordination of economic policies.

In addition, there needs to be a regular dialogue between the ECB and the central fiscal authority (while recognizing their respective responsibilities). This dialogue should take place in advance of significant budget statements and interest rate decisions, so that each can be informed by the other. The dialogue would cover all significant aspects of the ECB's remit (including liquidity policy, supervisory actions and resolution of failing banks, in addition to core monetary policy and its impact on the euro exchange rate), where they have fiscal and wider macroeconomic consequences. And the central fiscal authority would bring to the dialogue its responsibilities for national budgets, fiscal transfers and debt issuance, as well as the overall fiscal stance in the euro area.

This dialogue would in itself be a major step (both institutionally and in policy terms), since it would imply a much stronger level of coordination of fiscal policies across the euro area, and a recognition of the interactions between fiscal policies and the single monetary policy. But ideally it also needs to go further and cover macro-prudential and structural policies.

In sum, there needs to be better and stronger coordination of policies across the different arms of policy. This in turn requires better coordination both between member states and European institutions and between the different European institutions involved – the Commission, the Council, the Parliament, the ECB, the Eurogroup, and the central fiscal authority.

The changing landscape of governance: towards political union?

Since the crisis started, there has been a quickening in the trend towards greater centralization of responsibilities. Taken together, all these changes have resulted in a significant shift of power from the national to the European level. At the same time, creditor countries have been able to increase their influence over European economic decisions while debtor countries have become increasingly 'policy-takers'. The crisis countries have already had to adopt centrally determined policy changes in order to remain within the euro area and to access financial support. Increasing pressures to adapt national policies to meet standards set centrally, backed up with stronger sanctions for non-adherence, will extend this transfer process to all countries over time.

The proposals made in this chapter would imply a much more profound transfer of sovereignty from member states to European institutions. They go beyond what has been proposed so far by the 'Four Presidents' Report or the European Commission's Blueprint, and require a new overarching political solution to increase trust and solidarity among euro area countries. The risk is that decisions will be increasingly made at a level that most European citizens perceive as too remote.

This problem of the 'democratic deficit' has always existed in the EU. However, the level of economic integration required to make the euro sustainable, combined with the continuing preference of many politicians for continued intergovernmentalism in this highly political area, implies that this deficit will widen. This will inevitably generate demands in certain sectors for a greater political legitimacy within the euro area. In the long run, therefore, some degree of deeper political union to legitimize the transfer of economic power and sovereignty to the European level will be required. This could be achieved by moving towards electing the president of the Commission, as some have proposed,[72] or simply by strengthening the European Parliament's oversight of the institutions managing the single currency and its accompanying policies.

The EU and EMU will remain hybrid constructs, which will combine intergovernmental and community (supranational) methods, but if EMU is to survive in the coming years it will have to move towards further political centralization to legitimize deeper monetary, fiscal and economic union.

Whatever the precise outcome of this process, the implication of these debates and their search for a deeper political union among members of the euro area is that the division between members and non-members will inevitably widen. Coordination of core economic policies within the euro area would step up to another level. And the interactions between EMU and the single market mean that drawing the dividing lines between the responsibilities of the euro area and the EU as a whole would become even harder. Given the variable geometry of decision-making in the EU, this would throw up more demarcation disputes and potentially greater tensions between an increasingly larger (and therefore potentially more powerful) group of 'ins', and an increasingly smaller minority group of 'outs'.

Challenges to deeper integration

It is quite conceivable that by the end of this decade the euro area will have a full banking union and that it will have made further progress towards fiscal and economic cooperation. However, policy decisions will still be taken through intergovernmental procedures which can be implemented within the current legal framework. Significant further progress on fiscal integration would require a reform of the Lisbon Treaty, with decisions on fiscal issues increasingly being taken by community-based institutions and agencies. A new treaty would also allow changes to the mandate of the ECB, so that it could become a proper lender of last resort for the euro area. And it would legitimize stronger coordination and control by the Eurogroup and the Commission over structural economic policies.

Without this fundamental evolution, it is hard to see how euro area members will secure the deeper integration of economic governance that will be necessary to place EMU on a sustainable long-term footing. However, there are at least four important obstacles to this.

The first difficulty would be to manage Germany's increased power in Europe's political as well as its economic affairs. A widespread view in all other euro area countries is that Germany has the final say in almost every key decision of the European Council.

72 Some have proposed direct elections for the Commission president; others have suggested that the European Parliament should play the major role in appointing the president.

In principle, Germany certainly has the capacity and means to become the hegemonic stabilizer of the euro area,[73] as George Soros and the Polish foreign minister have called for. However, Germany is a reluctant hegemon given its recent history. This still leaves France, despite the relative decline of its own economic and political power within the enlarged EU, in the vanguard of the political debate over how best to achieve greater European economic integration.[74] The challenge is that France is perceived by many in Europe, including in Germany, as wanting to create a form of fiscal and economic union that would still leave political discretion and leadership to EU member states rather than to EU institutions.

Unalloyed German public support for greater political union has also faded, reflected most explicitly by the creation of the still small but symbolically important Alternative für Deutschland (AfD) party, which wants to return to the Deutsche Mark. The German government has also faced a series of challenges before the country's constitutional court in Karlsruhe to the constitutional legitimacy of the financial packages pledged to other euro members. Combined with ongoing criticism from former Bundesbank members about the viability of the ECB's current approach to managing the crisis in the euro area, the German political leadership as a whole is increasingly cautious about ceding further sovereignty to the centre of the union.

Germany's growing assertiveness on the shape of future economic and monetary union is making countries in the euro periphery more suspicious about its intentions. Whenever Berlin proposes further fiscal integration, for example through the establishment of a European minister of finance or the signing of binding contracts between member states and the European Commission, the response from other countries is usually negative. Germany's proposals are seen as mechanisms aimed at exerting supranational control over other members' fiscal expenditure, without giving anything additional, such as debt mutualization, in return.

A second obstacle is that a number of other countries are also reluctant to consider treaty reform. Two key countries in particular, France and the Netherlands, are likely to remain strongly opposed to a new convention because of their terrible experience with the attempted ratification of the constitutional treaty in 2005. The strength of opposition in their respective referendums to the proposed European constitution inflicted deep wounds on the political establishment of both countries. In France the referendum almost split the Socialist Party, and in the Netherlands it offered a springboard for nationalistic, and Eurosceptic, forces which until then had been marginalized.

The predominant feeling among euro area politicians is that, until growth resumes and unemployment falls, there will not be strong popular support for more integration at the European level. As a result, European leaders are wary of asking their citizens to vote on this.

Faced with the possibility that their citizens might reject the idea of further fiscal and political integration, European leaders are likely to opt for the intergovernmental route instead of treaty change for as long as possible. But this raises a third problem.

Intergovernmentalism has gained added momentum during the crisis. Both the ESM and the Fiscal Compact are intergovernmental agreements which circumvent the community method. The single resolution mechanism, as currently proposed, also stops short of giving resolution powers to a European-level institution. It is certainly feasible that the deeper fiscal integration recommended in this report, might first be organized on an intergovernmental basis. For example, giving more powers to the president of the Eurogroup while retaining final decision-making at the Council level would, in principle, not need a substantial treaty change.

But this approach brings with it a big problem: creditor countries retain sovereignty but debtor countries lose it. The intergovernmental process gives great weight to smaller creditor countries, so that the decision on a financial rescue package, for example, can be blocked by the parliament of Finland or Slovakia. While this might seem a democratic outcome for creditor countries, it risks disenfranchising citizens of the deficit countries, who already believe they have little influence on the decision-making process.

73 Matthijs and Blyth (2011).
74 Jabko (2012).

A fiscal union that replaces the 'community method' with asymmetric intergovernmentalism, in which creditors have much greater influence than debtors, will be highly divisive. To break this spiral of distrust, which has fuelled much of the rise of anti-euro parties, Europe's leaders will need to start pooling economic sovereignty at the transnational level, and this would necessarily imply treaty change.[75]

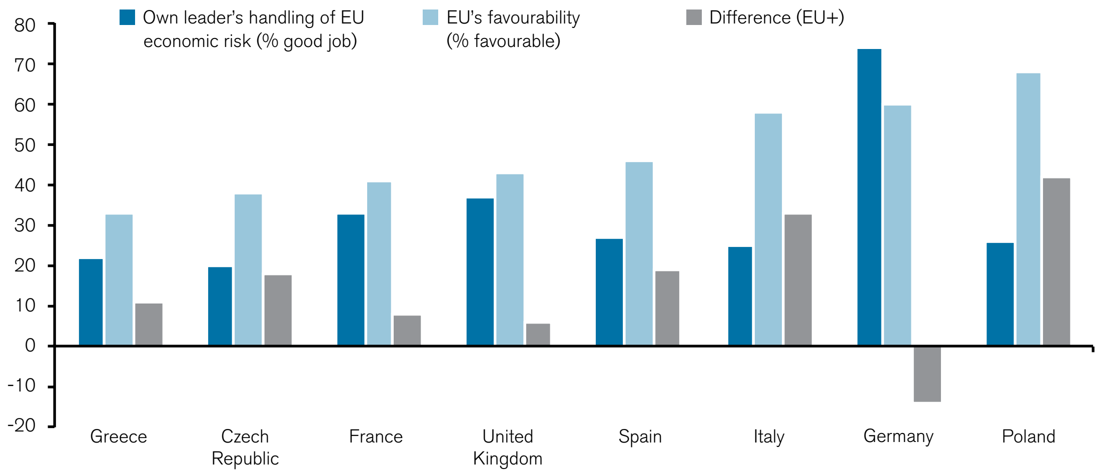
The fourth challenge concerns public opinion. If treaty change is the only possible path to construct a legitimate and more symmetric fiscal, banking, economic and political union, euro area leaders will have to start communicating this necessity to their electorates. At present, the narrative on deeper monetary union is largely negative and is often dominated by the Eurosceptics: political parties which either are openly anti-Europe – for example, the German AfD, the French Front National and Dutch Partij voor de Vrijheid, PVV (the Party for Freedom) – or which are opposed to EMU as it currently operates – such as the Italian MoVimento Cinque Stelle, M5S (Five Star Movement) or Syriza in Greece. These parties draw their support primarily from the deepening discontent with the political mainstream, which is exacerbated by continuing economic austerity and unemployment. On the far right, the EU is blamed for migration from Central and Eastern Europe. On the left, the EU is seen as a neoliberal project dominated by big banks and business to curtail the rights of workers.

However, despite recent growing popular support for Eurosceptic parties, opinion surveys show a more complex picture (see Figure 8). There is no doubt that the crisis has even more severely damaged the credibility and image of the EU as a whole both in creditor and in debtor countries (see Figure 9). But in the Southern countries attitudes towards national governments and institutions are even more negative than criticisms directed at the EU.[76]

Despite the crisis, overall attitudes towards the euro have remained strongly positive, both in the core and periphery of the euro area, with 63% overall in support, while they have turned sharply negative outside the currency bloc, where only 34% are in favour (see Figures 9 and 10).[77]

The Eurobarometer surveys also show that most European citizens are in favour of increasing economic cooperation at the European level.[78] This could potentially indicate that there is greater support for deeper fiscal and political union than some euro area leaders currently fear.

Figure 8: Popularity of EU and national leaders



Source: Pew Research Center (2013).

75 Otero-Iglesias (2013).

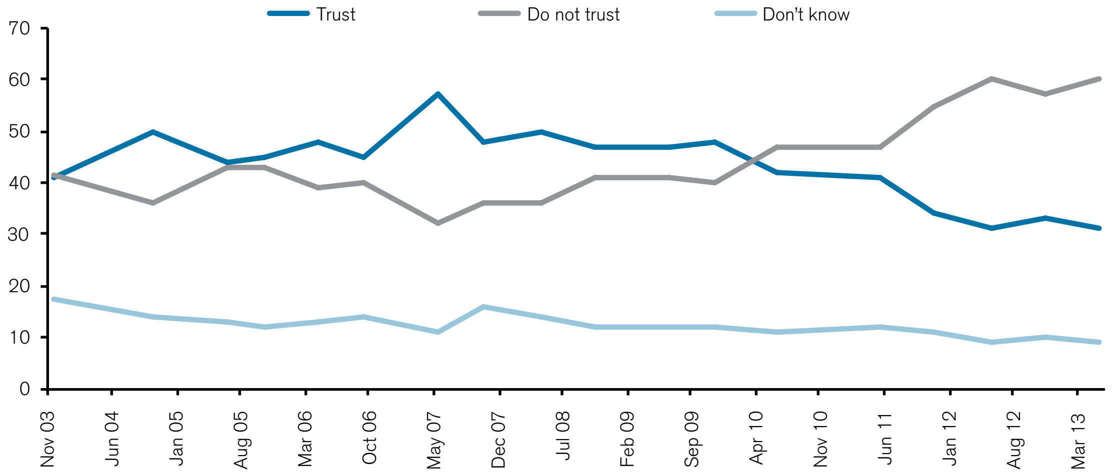
76 For a comprehensive study on how European attitudes have turned negative towards EU and national institutions in the aftermath of the crisis, but support for the euro has remained stable, see PEW Research Center (2013).

77 European Commission (2013c).

78 European Commission (2013b).

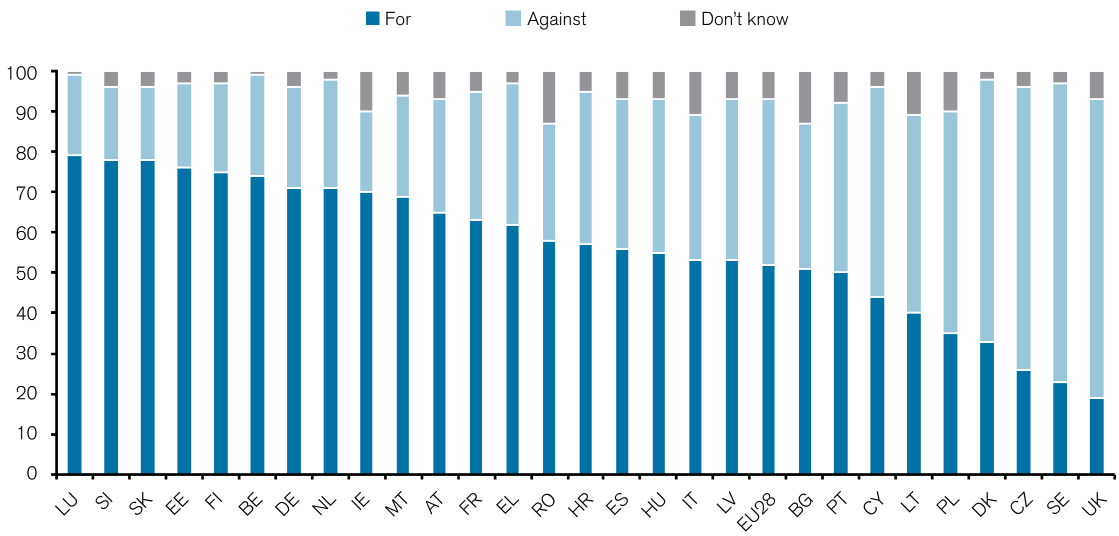
Hence the rise of Euroscepticism among European citizens might be overstated.[79] The elections to the European Parliament in May 2014 will be an important test. But, it is likely that public opinion will only be gauged accurately when voters are given an explicit choice between continued fragmentation, which leaves the euro exposed to structural weaknesses and recurrent crises, and greater integration and pooling of fiscal sovereignty, which may help strengthen the governance of EMU and make it more stable and sustainable.

Figure 9: Trust in the EU (% of respondents, EU-wide, who express trust in the EU)



Source: Eurobarometer.
Question asked: 'I would like to ask you a question about how much trust you have in certain institutions. For each of the following institutions, please tell me if you tend to trust it or tend not to trust it?'

Figure 10: Confidence in EMU (%)



Source: Eurobarometer.
Question asked: 'What is your opinion on the following statement? "A European economic and monetary union with one single currency, the euro".

79 Kirkegaard (2013) For a comprehensive in-depth analysis on Euroscepticism, see the special issue edited by Usherwood et al. (2013).

6. Conclusions

The design problems of EMU

The euro faced serious questions about its very survival in 2012. Action was taken then by the European Central Bank when Mario Draghi declared that it would do 'whatever it takes' to protect the euro. As a result these questions have receded for the moment. But major underlying issues remain.

The root causes of the crisis lay not only with weak financial oversight and lax fiscal policies, but also more fundamentally with the fundamental design of EMU and its governance. The original 1999 design of the Maastricht Treaty fell short in a number of respects. In particular the importance of labour and product flexibility and mobility was underplayed, and the significance of divergences in competitiveness between countries within the single currency area – and the resulting balance-of-payments surpluses and deficits – were largely ignored. Over time it has become clear that current account imbalances within the euro area were as much of a problem as fiscal unsustainability.

There is still a widespread view in parts of Europe that the main problem lies with countries' unwillingness or inability to implement the rules properly. This report has argued, instead, that strict adherence to the rules (in particular the fiscal rules) is not enough. In addition, deeper integration and the institutions to deliver this integration are needed. Without these further steps towards fiscal and economic integration, the monetary union will remain unstable and vulnerable to further shocks.

The response to the crisis

There have been many reform initiatives since the onset of the crisis across all aspects of economic policy – fiscal, financial, monetary and structural. Surveillance of national fiscal policies has been strengthened across the euro area. Financial system failures and regulatory shortcomings have been addressed. A framework for macroprudential policy has been constructed. And there are proposals to improve incentives for structural reform.

But these initiatives have not overcome the most important obstacle: the difficulty of reaching agreement on how the costs – of bailing out failing banks, of protecting depositors, and of transfers between member states – are to be shared out across the euro area.

Reforms to strengthen EMU

To tackle this obstacle, the reforms identified in this report as necessary for an effective EMU include steps towards:

- a fiscal union (including ensuring national fiscal sustainability, adequately funded fiscal transfers, and providing a fiscal backstop for sovereigns and banks);
- a banking union to enhance financial integration (with a common supervisor, a lender of last resort and common mechanism to resolve failing financial institutions, and a common deposit insurance scheme); and
- an economic union to facilitate convergence of competitiveness and innovation across the euro area.

These reforms are deeply interconnected and need to be closely integrated. And they require a legitimate governance structure.

Fiscal policies across Europe need to be credible and sustainable. But they also need to be flexible enough to respond to country-specific shocks, and to ensure that the burden of adjustment to competitiveness gaps is shared more symmetrically between 'surplus' and 'deficit' countries. Finally, they need to be better coordinated so that aggregate fiscal policy settings are set appropriately at the euro area. Overall, rules are not – and cannot be – effective substitutes for common institutions. In terms of fiscal policy, tighter rules do not amount to greater fiscal integration.

Common institutions will need to include a new central fiscal authority, which would have the authority to transfer funds between member states in order to assist with economic adjustment to structural imbalances within the euro area, and to set fiscal policy at the euro area level. Ultimately, this will only be possible under a single central treasury within the euro area with powers to monitor national accounts and with the authority to demand changes to national budgets, to determine fiscal transfers, to issue debt and to collect euro-area-wide taxes. Euro area members may sometimes need support in order to implement painful structural reforms. The Eurogroup is best placed to coordinate national reforms, but, over time, there will need to be some financial support from a central fiscal capacity for national efforts that will benefit the euro area as a whole over the long term.

The SRM and single deposit guarantee mechanism still need a sufficiently large and credible common fiscal backstop, which eventually will have to be provided by the central fiscal authority.

In the long run, a sustainable monetary union in the euro area also requires that the ECB can play the function of an unconditional lender of last resort for sovereigns in exceptional circumstances. For this to happen, the Maastricht Treaty will have to be amended.

EMU also requires much stronger coordination across all aspects of economic policy, in particular a strong mechanism for coordinating fiscal and monetary policy, financial and macro-prudential policies. The Eurogroup is at present best placed to coordinate national macroeconomic policies. But as powers are increasingly centralized, there needs to be a deepening dialogue between the ECB and the central fiscal authority.

These proposals would imply a profound transfer of sovereignty from member states to European institutions, with many important decisions made at a level that most European citizens currently perceive as too remote. As the level of economic integration required to fix the euro increases, this 'democratic deficit' will widen. Therefore, in the long run, some degree of political union will be required to legitimize this new governance structure.

A timeline for change

By the end of this decade most elements of the banking union should be in place. The Single Supervisory Mechanism should be fully operational and the Single Resolution Mechanism should have a framework in place and a resolution fund financed through banking-sector levies, although it will still need a substantial fiscal backstop. The common deposit insurance scheme will probably not be operational by then, but plans to mutualize it could be in place.

Beyond 2020, however, a new treaty will almost certainly be required to strengthen the fiscal, financial and economic union, and to work out how to share costs across the euro area.

Many euro area politicians feel that until the crisis is over, growth resumes and unemployment falls, there will not be sufficient popular support for more integration at the European level. In the face of this Euroscepticism, European leaders are likely to opt in the first instance for the intergovernmental route. But pooling economic sovereignty at the transnational level will at some point necessitate treaty change. If treaty change is the only possible path to construct a legitimate and more symmetric fiscal, banking, economic and political union, euro area leaders have to start communicating this to their electorates as soon as possible and get public opinion on board.

Voters need to be given a real choice between continued fragmentation which leaves the euro exposed to structural weaknesses and recurrent crises, and greater integration which pools more sovereignty and at the same time strengthens the governance of EMU. Banking, fiscal, economic – and eventually political – unions are necessary for EMU to be more integrated, and ultimately more stable, sustainable and prosperous.

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